

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of)
)
Review of the Commission's Rules Regarding)
the Pricing of Unbundled Network Elements) WC Docket No. 03-173
and the Resale of Service by Incumbent Local)
Exchange Carriers)

COMMENTS OF QWEST COMMUNICATIONS INTERNATIONAL INC.

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SUMMARY

Qwest applauds the Commission for initiating this proceeding, and urges the Commission promptly to adopt its tentative conclusion that determinations of UNE prices should incorporate “real-world boundaries,” and to modify and clarify its rules to implement that conclusion. Any other result would be devastating to the prospects for facilities-based competition, and the investment that is required to provide the innovative, high-quality services demanded by consumers.

The fundamental question in this proceeding is whether the UNE cost inquiry should be based on the “actual prices” and “best practices” of the ILECs “as they install new network elements or replace existing ones,” as AT&T told the Supreme Court,¹ or upon “unverifiable” estimates of costs that assume the deployment of “theoretically feasible” technologies and practices within a “hypothetical” network, as they have told state commissions. By urging the latter, the CLECs have succeeded in converting TELRIC into a mandate to reduce UNE rates to successively lower levels in order to produce “the widest unbundling possible,” an objective held by the D.C. Circuit to be incompatible with the Act, and by the Commission to be contrary to its desire that TELRIC prices “not create incentives for carriers to avoid investment in facilities.”

*Notice ¶ 3.*²

¹ Reply Brief of AT&T Corp. at 17 (filed July 23, 2001), *Verizon v. FCC*, 535 U.S. 467 (2002)(arguing that TELRIC rates are based on “‘actual prices’ that prevail” when “LECs install new network elements or replace existing ones using efficient technology,” and on “the best practices” of the ILECs).

² Compare *USTA v. FCC*, 290 F.2d 415 (D.C. Cir. 2002) and *Notice ¶ 3*, with Joint Opposition of CLEC Intervenors to Qwest's Initial Brief as 20 (filed Nov. 24, 2003), *Qwest v. Koppendraye*, Civil File 03-3943 ADM/AJB (D. Minn.)(“primary goal of the 1996 Act’s UNE pricing regime” is to “encourage competitive entry” through resale of ILEC facilities).

The CLECs' "excessively hypothetical" (*Notice ¶ 7*) approach to TELRIC in state commission proceedings artificially reduces costs for the sole purpose of allowing them to resell the ILEC's network, and avoid investment in facilities of their own. The results of this approach, if allowed to continue, would be devastating for consumers and the economy. Prices that are set below cost have a stifling effect on investment. This is not merely an economic truism, but common sense. Without sufficient investment, the telecommunications industry cannot continue to provide the reliable, high-quality services demanded by consumers, or "achieve the rapid deployment of new technologies" necessary to maintain this nation's leadership position in the global economy. Investment is also vital to the development of facilities-based competition, the only form of competition capable of providing consumers with genuine choices in terms of features, functionality, service quality, reliability, network redundancy, and sustainable lower prices.

To artificially reduce the prices they pay to resell Qwest's network, and avoid investing in facilities of their own, the CLECs have developed and proposed the adoption of estimated costs that would be incurred to build and operate a hypothetical network, embodying an array of counterintuitive, unverifiable and patently inconsistent assumptions. According to the CLECs' advocacy in state commission proceedings, for example:

- While TELRIC assumes the deployment of the most efficient technologies and practices that may be available in the future, it also requires that structure sharing, placement and other inputs be determined as of long ago, when the ILEC networks were first built and, according to legend, the "digging was easy" and "sharing was plentiful."
- Cable mileage and other inputs may be based upon mathematical "algorithms" that, by their own admission, ignore generally accepted principles of network design, and fail to account for natural and artificial obstacles, including limits on the availability and costs of rights-of-way other than those through which the ILEC's network is routed.

- TELRIC requires the exclusion from non-recurring charges of virtually all costs incurred to manually process CLEC orders on the ground that the systems of a “hypothetically” efficient ILEC would be fully automated; at the same time, the CLECs exclude the costs to obtain and install the fully automated systems assumed by their proposed NRCs.
- The models and inputs used to determine TELRIC prices may be based on the hypothetical musings of “experts” retained by their advocates, and that “details” such as work papers and independent evidence verifying their methodology or conclusions are unnecessary.
- Evidence of the current, actual costs and practices of Qwest, other ILECs, and facilities-based CLECs may not even be considered to evaluate the reliability or reasonableness of the models and inputs proposed by resale CLECs for the purpose of determining UNE rates, because they are real and not hypothetical, as TELRIC purportedly requires.
- TELRIC requires or permits estimates of operating expenses that are 70% or more lower than those that Qwest actually incurs today (which reflect the efficiency incentives of more than ten years of price cap regulation at both the federal and state level).
- The paltry level of operating expenses proposed by the CLECs may be adopted without: (1) any evidence that any facilities-based carrier has been able to reduce expenses by amounts even close to the levels they propose, (2) identification of any action that Qwest could take to reduce expenses from current levels, or (3) any explanation how Qwest could reduce its workforce by 70% or more, as implied by their proposals, and maintain service quality at levels demanded by state commissions and consumers.

The urgent need for “modifications” of and “clarifications” to the Commission’s pricing rules is underscored by its observation only a few months ago that “estimates of costs” developed exclusively for use in regulatory proceedings can be “difficult to verify” and “easily manipulated by advocates.” *Triennial Review Order* ¶ 99. These observations are even more pertinent to UNE rates, which have largely been determined based on models and inputs developed by consultants, directed by the CLECs’ advocates, solely for use in regulatory proceedings. Indeed, the difficulties of verifying cost estimates, and their susceptibility to “manipulation by advocates” are increased dramatically when the “costs” that are the subject of

the “estimates” are those that would be incurred to build and operate a “hypothetical” network.³ It is simply impossible to reconcile the Commission’s observations in the *Triennial Review Order* about the reliability of cost estimates with the prevailing interpretation and application of TELRIC.

Accordingly, Qwest urges the Commission to restore “real-world boundaries” and evidentiary rigor to the UNE cost inquiry. Specifically, in Part I of these comments, Qwest urges the Commission to amend part 51 of its rules to: (1) require that cost determinations be based on the most efficient network designs, technologies and practices that have actually been deployed on a scope and scale comparable to that of the ILEC, as demonstrated by marketplace evidence, and (2) adopt a rebuttable presumption that the most efficient technologies, designs and practices that have actually been deployed by the ILEC, and the ILEC’s actual expenses (which reflect the efficiency incentives of more than ten years of price cap regulation at both the federal and state level) satisfy the foregoing standard.⁴

The Commission should also codify in part 51 of its rules several core principles in addition to those set forth above. In particular, the Commission should reaffirm that TELRIC is to be determined with reference to current constraints and other conditions external to the

³ Thus, as one federal court has explained after reviewing the record compiled in a UNE cost docket, TELRIC in application allows each party to offer its own vision of [a] mythical network, limited only by the party’s audacity and its ability to procure an expert witness willing to endorse that party’s vision.” *U S West Communications, Inc. v. Jennings*, 46 F. Supp. 2d 1004, 1009 (D. Ariz. 1999). The “excessively hypothetical” nature of and inconsistent assumptions required under the prevailing view of TELRIC led the Colorado commission to opine that it is “founded on quicksand.” Decision No. C01-1302, *In the Matter of U S West Communications, Inc.’s Statement of Generally Available Terms and Conditions*, Docket No. 991-577T (CO PUC rel. Dec. 21, 2001) at 13.

⁴ The presumption proposed by Qwest would be subject to adjustment based on the deployment of different and more efficient technologies, designs and practices, resulting in lower investment and expenses, by other carriers on a scope and scale comparable to the ILEC, as demonstrated by marketplace evidence.

network, including the amount and location of developed “areas.” Such action is necessary to prevent CLECs from continuing to urge the adoption of the “backward looking” approach for structuring sharing, placement and other inputs. *Notice* ¶ 47.

The Commission should also clarify that its UNE pricing rules require the use of models, inputs and assumptions that are consistent within the three components of costs (*i.e.*, operating costs, depreciation expense and return on capital), as well as within elements, across elements, and across recurring and non-recurring charges. Under such a rule, CLECs could not continue to understate UNE costs, and thereby distort the pricing signals that rates are supposed to provide, by excluding virtually all costs incurred to manually process CLEC orders, without incorporating the costs of the automated systems assumed by their proposals. In addition, part 51 should be amended to require that proposed cost models, inputs and assumptions used to set UNE rates be transparent, verifiable and explained with specificity. Under such a rule, it would not be permissible, for example, to base rates for high-capacity loops on a model, such as the HAI “Adjunct Model,” that calculates investment with no identification of the underlying prices of necessary multiplexing and other equipment, much less allow for the verification of such prices.

Part II of these comments expands upon and applies to specific inputs the rules and principles described in Part I. Among other things, Part II sets forth proposals to impose real world boundaries on network assumptions relating to routing, structure sharing, plant mix and placement, and fill factors. Part II also explains that there is no justification for using “factors” to estimate most types of operating expenses. No party has demonstrated the existence of any significant correlation between changes in per line investment and expenses, which is the fundamental premise of a factors-based approach. With respect to cost of capital, the Commission should at a minimum require state commissions to fully account for all risks

inherent in the assumptions required by or adopted pursuant to the Commission's rules. These include but are not limited to risks inherent in the operation of a ubiquitous local network in a market with "widespread" facilities-based competition. *Notice* ¶ 10. Moreover, because the key assumptions underlying cost of capital determinations do not vary by state, and because capital markets are national if not global, the Commission should itself prescribe the cost of capital reflected in UNE rates. By prescribing cost of capital, the Commission would reduce the "burden on state commissions," and ensure "consistent" determinations, in furtherance of the Commission's goals. Such a prescription should be based on the cost of capital of other carriers operating today in competitive markets, namely the CLECs and interexchange carriers.

The Commission should also require that the costs of non-recurring activities be recovered through non-recurring charges, consistent with fundamental economic principles. In this regard, the source of the "risks" to CLECs described in the *Notice* is not a rate structure that adheres to economic principles, but participation in a competitive market. All carriers, including ILECs and facilities-based CLECs, are at risk of losing customers to competitors prior to recovering their "up front" costs. Insulating resale CLECs exclusively from these risks would not merely provide them with an artificial competitive advantage, but would provide an additional reason for competitors to prefer resale over facilities-based methods of entry -- contrary to the Commission's objectives.

Part III of these comments proposes additional evidentiary and procedural guidelines that would increase the availability and objectivity of information used to determine UNE rates. First, consistent with concerns about "transparency" and "verifiability," the Commission should require disclosure in UNE rate proceedings, subject to protective orders, of data in the possession, custody or control of other facilities-based carriers relevant to their network costs,

and prohibit the use of models, inputs and assumptions that rely on data, including those owned or controlled by third parties, that have not been made available to opposing parties. Second, the Commission should extend to UNE rate proceedings the approach to the “burden of proof” adopted in the *Triennial Review Order*. Third, to prevent further misuse of determinations made in the universal service context (*Notice* ¶ 47), the Commission should state unequivocally that those determinations may not be relied upon, in whole or in part, to adopt or reject proposals in UNE rate proceedings. Fourth, the Commission should reaffirm and comply with its commitment to issue in subsequent proceedings additional binding guidance, in response to petitions for declaratory rulings and primary jurisdiction referrals by the courts, on the interpretation and application of its revised pricing rules. The use of these mechanisms is especially critical to ensure that equal attention is paid to ILEC claims regarding the misapplications of TELRIC as is paid to CLEC claims under section 271(d)(6), thereby ensuring that TELRIC prices provide “correct economic signals.” *See Notice* ¶¶ 27-28.

Finally, for the reasons explained in Part IV, the Commission should provide specific, even-handed and binding guidance on the lawfulness and propriety of true-ups of rates that had been found by the state commission upon their adoption to be TELRIC-compliant. This is a matter of considerable urgency, for AT&T, MCI and other resale CLECs are now arguing to courts that state commissions may without limitation order true-ups of “permanent” rates, that the Commission has “encouraged” such true-ups, and that the *Notice* “proves” that true-ups are “authorized by federal statute and the FCC’s practice.” The mere possibility of true-ups in any and all circumstances would utterly negate the “predictability” and “certainty” that the Commission has properly recognized to be essential to its “desire that UNE prices send the correct economic signals” (*Notice* ¶ 7). Accordingly, the Commission should not limit the

guidance it provides on true-ups to their propriety based on the application of the other rules that emerge from this proceeding, but should address the propriety of true-ups in other circumstances as well.

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COMMENTS OF QWEST COMMUNICATIONS INTERNATIONAL INC.

Qwest Communications International Inc. ("Qwest") respectfully submits these Comments in response to the Federal Communications Commission's ("Commission" or "FCC") *Notice of Proposed Rulemaking* in the above-captioned proceeding.^{1/}

INTRODUCTION

Qwest applauds the Commission for initiating this proceeding, and proposing substantive and "evidentiary guidelines" (*Notice* ¶ 145) that will restore "real-world boundaries" (*id.* ¶ 48) to the cost inquiry for unbundled network elements ("UNEs"). Seven years ago, the Commission recognized that UNE prices "are critical terms and conditions of any interconnection agreement,"² and promised to "issue additional guidance on its TELRIC pricing methodology

¹ Notice of Proposed Rulemaking, *Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, WC Docket No. 03-173, FCC 03-224 (rel. Sept. 15, 2003) ("*Notice*").

² First Report and Order, *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, 11 FCC Rcd 15499, 15812 ¶ 618 (1996) ("*Local Competition Order*"), *aff'd in part and vacated in part, sub nom. CompTel v. FCC*, 117 F.3d 1068 (8th Cir. 1997) and *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997), *aff'd in part and remanded, AT&T v. Iowa Utils. Bd.*, 525 U.S. 366 (1999) ("*AT&T v. Iowa Utils.*"); *on remand, Iowa Utils. Bd v. FCC*, 219 F.3d 744 (8th Cir. 2000), *reversed in part sub nom. Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002).

“[i]n the aftermath of arbitrations and relying on the state experience.”³ That guidance, essential to achieving the congressional goal of facilities-based competition, is now long overdue.

In recent years, non-facilities based competitive local exchange carriers (“CLECs”) and many state commissions have treated TELRIC not as the economically objective methodology the Commission intended, but as a mandate to reduce rates in order to produce “the widest unbundling possible,” an objective that the D.C. Circuit has rejected as incompatible with the statutory design.⁴ The use or application of TELRIC to reduce costs below levels that are economically reasonable is plainly contrary to Congress’s stated intention to “secure . . . higher quality services” and to “encourage the rapid deployment of new telecommunications technology.”⁵

Nevertheless, even following release of the *Notice*, AT&T, MCI and other resale CLECs have continued to advise state commissions and federal courts that the Commission believes that continued reductions in UNE rates adopted for the purpose of “encourag[ing] competitive entry” through resale of the ILEC’s facilities are “the primary goal of the 1996 Act’s UNE pricing regime.”⁶ Qwest therefore urges the Commission to issue -- as promptly as possible -- comprehensive, binding guidance to conform the application of TELRIC to the purposes set forth in the *Notice*.

³ *Local Competition Order*, 11 FCC Rcd at 15813 ¶ 620.

⁴ *United States Telecom Ass’n. v. FCC*, 290 F.3d 415, 424 (D.C. Cir. 2002), *cert. denied*, 123 S.Ct. 1571 (2003) (“*USTA v. FCC*”).

⁵ Telecommunications Act of 1996, Preamble.

⁶ Joint Opposition of CLEC Intervenors, *Qwest v. Koppendray*, Civil File No. 03-2942 ADM/AJB (D. Minn.), filed Nov. 24, 2003, at 20.

In particular, Qwest agrees with the Commission that the public interest, as reflected in the Act, is best served by UNE prices that: (1) create economically rational price signals for CLECs as they choose between leasing facilities from incumbent local exchange carriers (“ILECs”) and procuring their own, and (2) provide compensation to ILECs in amounts and intervals that will allow them to maintain and upgrade their networks.⁷ Central to both objectives of UNE pricing is encouraging investment. Without sufficient investment, the telecommunications industry cannot continue to provide the reliable, high quality and innovative services that are demanded by consumers and necessary to maintain this nation’s leadership position in the global economy. Investment is also vital to the development of facilities-based competition, the only form of competition capable of providing consumers with genuine choices in terms of features and functionality, service quality, network redundancy and reliability, and sustainable lower prices.⁸

The “synthetic” form of “resale” competition that depends upon the UNE-Platform, by contrast, offers none of these benefits.⁹ In particular, companies that are induced by artificially low prices to use the same network platform to provide service to retail customers cannot offer

⁷ *Local Competition Order*, 11 FCC Rcd at 15844 ¶ 672; *Notice* ¶ 38.

⁸ “Through its experience over the last five years in implementing the 1996 Act, the Commission has learned that only by encouraging CLECs to build their own facilities or migrate toward facilities-based entry will real and long-lasting competition take root in the local market.” See Fourth Report and Order, *Deployment of Wireline Services Offering Advanced Telecommunications Capability*, 16 FCC Rcd 15435, 15437 ¶ 4 (2001). The Act’s preamble, which the Commission has stated “gives the best snapshot of Congress’s overall intent” in the 1996 Act (Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, Review of the Section 251 unbundling Obligations of Incumbent Local Exchange Carriers, CC Docket Nos. 01-338, 96-98 and 98-147, FCC 03-36, (rel. Aug. 21, 2003) ¶ 70 (“*Triennial Review Order*”), emphasizes “reduced regulation” the “deployment of new technologies,” “higher quality services” and “lower prices for consumers,” each of which can only be achieved by facilities-based competition, at least in the long term.

⁹ *USTA v. FCC*, 290 F.3d at 424.

features, functionality, quality or reliability different than those of the ILEC.¹⁰ Indeed, the only basis upon which resellers can differentiate themselves from the ILEC and each other is marketing.¹¹ No one would suggest, however, that the bold ambitions of the 1996 Act are satisfied by increases in the frequency and intensity of telemarketing calls.

For the same reason, *i.e.*, the absence of any benefit to the public in terms of service quality and innovation, the possibility of lower prices in the short-term is the only “public” benefit that AT&T, MCI and other UNE-based CLECs can even assert is provided by their approach to TELRIC. That purported benefit, however, does not offset the harms caused by stifling investment in existing and new facilities, and is ephemeral at best.¹² An artificially low price is of no value to consumers if facilities-based sellers are unwilling or unable to supply the service at that price, or make the capital investment that renders possible the supply of that service.¹³ The inevitable result of such a scheme is to diminish or foreclose the possibility of

¹⁰ *AT&T v. Iowa Utilities Board*, 525 U.S. at 429 (Justice Breyer, dissenting)(“[i]t is in the unshared, not in the shared, portions of the enterprise that meaningful competition would likely emerge”); G. Rosston and R. Noll, “*The Economics of the Supreme Court’s Decision on Forward-Looking Costs*,” 1 Review of Network Economics 81, 89 (2002)(“consumers are not likely to benefit” if “most local access competition [takes] the form of resale of the incumbent’s facilities”).

¹¹ T. Hazlett, A. Havenner, “*The Arbitrage Mirage: Regulated Access Prices With Free Entry in Local Telecommunications Markets*,” 2 Review of Network Economics 440 (Dec. 2003) (“*Hazlett/Havenner*”).

¹² A recent paper prepared for NARUC, authored with several colleagues by an economist who has served as a consultant on TELRIC to the Washington and New Mexico commissions, Dr. David Gabel, has explained that pricing UNEs below cost “harms investment, and hence innovation, as well as competition and consumer welfare in the longer term.” See D. Gabel, E. Ralph, S. Kennedy, “*An Approach to Analysis of Impairment for Unbundled Switching*,” Sept. 2003 (“*Gabel*”) at 55; *id.* (economic “theory” teaches that “welfare losses can be considerably higher when UNE prices are set below costs, than when UNE prices overstate costs”).

¹³ See “*The Theoretical Economic Principles Underlying TELRIC*,” by Professor Dennis L. Weisman, Dec. 16, 2003 at 3-4, attached herewith (“*Weisman*”). Moreover, any margins available to ILECs and CLECs -- already nonexistent or limited due to retail rates kept

facilities-based competition,¹⁴ and upgrades to ILEC networks, and could even include impairment of the reliability and quality of those networks as they exist today.¹⁵

The data confirm that TELRIC, as implemented, has substantially depressed investment in alternative facilities, and failed to support capital expenditures by ILECs. In a mere three years, overall annual investment by all wireline telecommunication carriers, including ILECs and CLECs, declined by over 60%, from \$104.8 billion in 2000 to \$42.8 billion in 2002.¹⁶

Investment by facilities-based CLECs declined by 19% from 2000 to 2001, and by 56% from

artificially low by legacy local regulation -- are consumed by the growing marketing expenditures necessary to differentiate themselves. *See Hazlett/Havenner* at 442-45; Morgan Stanley Equity Research, Wireline Telecom Services (March 2003) (“*Morgan Stanley Equity Research*”) at 13 (“questioning the profitability of the UNE-P offering” because of “significant marketing and advertising expense”); the CLECs’ response, as discussed below, is to alter the cost models upon which they rely in UNE cost dockets to “justify” even further reductions in UNE rates, the effect of which is to require the ILECs to subsidize not merely their product acquisition costs, but their marketing costs as well. This phenomenon undoubtedly explains why the latest version of the CLEC-sponsored HAI model, for example, cuts by almost 50% the loop prices calculated by the prior version. *See infra* at 13. No system like this can sustain itself. *See Morgan Stanley Equity Research* at 14 (with TELRIC, “the FCC may simply have perpetuated a reseller bubble with no profitability that will ultimately burst”).

¹⁴ There is unanimous agreement on this point by the Commission, the courts and economists. *See Notice* ¶ 3 (“[t]o the extent that the application of . . . TELRIC pricing rules distorts [the Commission’s] intended pricing signals by understating forward-looking costs, it can thwart one of the central purposes of the Act: the promotion of facilities-based competition.”); *AT&T Communs. Of Ill. v. Il. Bell Tel. Co.*, 2003 U.S. App. LEXIS 22961 (“Prices for unbundled elements affect not only the allocation of income among producers but also new investment and innovation: if the price to rivals is too low, they won’t build their own plant (why make capital investments when you can buy for less, one unbundled element at a time?), and the incumbents won’t maintain or upgrade their facilities (why make costly capital investments if you have to sell local loops to rivals for less than it costs to produce them?)”); *Hazlett/Havenner* at 441-42 (low UNE prices “induce[] the competitive entrant to substitute UNEs for facilities it might build”).

¹⁵ *Id.* (low UNE “price signal also induces investors in incumbent networks to reallocate capital” to “alternative projects” outside telecommunications); *see also Weisman* ¶ 59; *Gabel* at 55 (“[t]oo little investment results in too little service of inefficiently poor quality”).

¹⁶ Skyline Marketing Group, *CapEx Report: 2002 Annual Report*, Carrier Data Sheet 1 (June 2003).

2001 to 2002.¹⁷ Not coincidentally, as facilities based investment has plummeted, the use of UNE-P has exploded, due in substantial measure to the downward spiral in UNE prices.¹⁸ It thus could not be clearer that “the application of . . . TELRIC pricing rules” has in fact “distort[ed] [the Commission’s] intended pricing signals by understating forward-looking costs,” thwarting “the promotion of facilities-based competition.” *Notice* ¶ 3.

As implemented, TELRIC has also failed to adequately compensate, and has thus deterred sufficient investment by, ILECs. For example, the CLEC-sponsored cost models adopted by some state commissions to determine costs permit the recovery of only 30% (*infra* at 12) of the expenses that Qwest actually incurs. It is not surprising, therefore, that BOC capital expenditures have declined by approximately 35% from 2001 to 2002.¹⁹

Against this background, the language chosen by the Commission to reaffirm its decision to mandate a forward-looking approach is particularly significant. In particular, the *Notice* expressly conditions its conclusions regarding the relationship between a forward-looking approach to UNE prices and the sending of appropriate investment signals on the “assum[ption] that the modeling method is accurate.” *Notice* ¶ 30. That assumption has proven to be unfounded. In UNE rate proceedings, cost estimates are based generally on models developed

¹⁷ Association for Local Telecommunications Services, *The State of Local Competition* 2003 at 10 (April 2003). While CLEC investment in facilities declined, CLEC revenues grew, from \$43 billion in 2000 to \$52 billion 2002. As a result, CLEC capex as a percentage of revenues plunged from 63.7% in 2000 to 14.3% in 2002. *Id.* at 11.

¹⁸ From 2000 through 2002, UNE-P lines nationwide grew by 1900%, from 500,000 to more than 10 million. *See* Ind. Anal. & Tech. Div (FCC), *Local Telephone Competition: Status as of December 31, 2002*, at Table 4 (June 2003). In Qwest’s region, the number of UNE-P lines grew by 47% between January 2002 and June 2003 (from almost 460,000 to over 675,000). During the first half of 2003, the monthly growth rate in UNE-P lines increased by 840%. In contrast, during the same period, the monthly growth rate for CLEC purchases of unbundled loops other than as part of the UNE-Platform declined by 40%.

¹⁹ UBS Warburg, *Are the Bells Growing Less Profitable?* at 41 (Apr. 16, 2003).

and supported by consultants controlled by advocates exclusively for use in regulatory proceedings.²⁰ As the Commission recognized recently in its *Triennial Review Order* (¶ 99), however, “cost estimates” calculated by models and inputs developed exclusively for use in regulatory proceedings “are difficult to verify” and “easily manipulated by advocates.” *Id.* That is especially the case when the subject of those models and inputs is the costing of a hypothetical network, and all real-world information is deemed irrelevant. Indeed, at least one state commission has interpreted TELRIC to require the adoption of assumptions that are “*fanciful* in terms of what real forward-looking costs will be.”²¹

More specifically, in UNE rate proceedings, CLECs propose, and many state commissions adopt, “cost estimates” generated by models and inputs, prepared exclusively for advocacy purposes, that incorporate “the speculative attributes of a purely hypothetical network.” *Notice* ¶ 4. Thus, as one federal court has explained after reviewing the record compiled in a UNE cost docket, TELRIC in application allows each party “to offer its own vision of [a] mythical network, limited only by the party’s audacity and its ability to procure an expert witness willing to endorse that party’s vision.”²² Many of the inputs proposed by CLECs

²⁰ The CLECs offer no evidence that their models and assumptions, or the approaches they employ, are used by telecommunications executives and investors in preparing or evaluating a business case.

²¹ Ruling On Applications For Rehearing, Reargument, Or Reconsideration, Decision No. C02-409, *In the Matter of U S WEST COMMUNICATIONS, INC. 's Statement of Generally Available Terms and Conditions*, DOCKET NO. 99A-577T (CO PUC), Apr. 17, 2002 (“*CO PUC Cost Docket Rehearing Order*”), at 31 (emphasis added).

²² *U.S. West Communication, Inc. v. Jennings*, 46 F. Supp. 2d 1004, 1009 (D. Ariz 1999). See also Raymond L. Gifford, “*Regulatory Impressionism, What Regulators Can and Cannot Do*,” 2 Review of Network Economics December 2003) (“*Gifford*”) at 474 (“[b]ecause the methodology is theoretical,” TELRIC, “thus practiced, becomes not a careful principled analysis of forward-looking rates (that cannot be done because the assumptions are the whole game), but rather a vehicle for creating a margin between wholesale and retail rates”); Tenth Report and Order, *Federal-State Joint Board on Universal Service*, 14 FCC Rcd 20156, 20430 (1999)

and adopted by state commissions are “based solely on the unsubstantiated opinions” of expert or other interested witnesses,²³ notwithstanding the admonitions of this Commission and the Wireline Competition Bureau (“Bureau”).²⁴

In stark contrast to the preference for “actual marketplace evidence” expressed in the *Triennial Review Order*, CLECs rarely if ever provide evidence that any carrier (ILEC or CLEC) has deployed the designs, technologies and practices, or achieved the results, assumed by their proposed cost models and inputs. CLECs even deem irrelevant the fact that their hypothetical

(“*Inputs Order*”), *aff’d sub nom. Qwest Corp. v. FCC*, 258 F.3d 1191 (10th Cir. 2001) (dissenting statement of Commissioner Harold Furchtgott-Roth) (describing Synthesis Model as “an immensely complicated computer program . . . completely dependent on hundreds of assumptions about the local exchange market and costs,” and observing that “simply by making different assumptions about local exchange networks, or by picking different input values for costs, the Commission is able to push the end result in whatever direction it chooses.”).

²³ See, e.g., *In the Matter of the Commission’s Review and Investigation Of Qwest’s Unbundled Network Element Prices*, Docket No. P-421, C1-01-1375 (“MN Cost Docket”), Findings of Fact, Conclusions of Law and Recommendation, August 2, 2002, ¶ 278 of November 17, 1998 Report of the Administrative Law Judge (adopting non-recurring cost model proposed by AT&T and reasoning that “[w]hile MCI and AT&T did not provide any work papers supporting its assumption that certain costs could be recovered through a recurring charge or of its time estimates and probabilities of certain work activities occurring, it [sic] indicated that these assumptions were based on the professional judgment of its [sic] experts”), *adopted by Order Setting Prices and Establishing Procedural Schedule, In the Matter of the Commission Review and Investigation of Qwest’s Unbundled Network Element Prices*, P-421/CI-01-1375, Oct. 2, 2002 (collectively, “*MN Cost Docket Order*”); *id.* ¶ 133 (lack of documentation of “investment expense” proposed by AT&T/WCOM does not preclude rejection where witness “confirmed the validity” of the proposal); *id.* ¶ 123 (accepting CLEC-proposed “DLC” adjustment to switching investment determined by SM model based on conclusory assertion of AT&T witness, rejected by the FCC, that SM investment assumed only 18.3% DLC); *id.* ¶ 54 (accepting loop plant mix proposal based on unexplained interpretation of “expert” witness of undisclosed survey results).

²⁴ See, e.g., Memorandum Opinion and Order, *In the Matter of Petition of WorldCom, Inc. Pursuant to Section 252(e)(5) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia Inc., and for Expedited Arbitration*, 18 FCC Rcd 17722 (2003) (“*Wireline Competition Bureau VA Arbitration Order*”) at 17828-29 ¶ 274 (observing that the Commission has “generally declined to rely on unsubstantiated witness opinion to support a party’s cost proposal”); see also *id.* at 17830-31 ¶ 278, 17849-50 ¶ 326, 17946 ¶ 571.

network is based on a design that is not used in the “real world,” and that no one would “use in engineering.”²⁵

The CLECs’ “hypothetical” approach to TELRIC in UNE rate proceedings is also hypocritical. In various proceedings, CLECs have presented their estimates of the forward-looking costs of an “efficient” operator as part of their efforts to demonstrate “impairment” without access to UNEs. In doing so, they have based their estimates on their own “current actual costs” “reduced by a factor to account for productivity increases.”²⁶ When ILECs calculate in a similar manner their forward looking costs to provide UNEs, however, the CLECs argue that the ILECs’ “actual costs are irrelevant” to the hypothetical TELRIC inquiry, and may not even be considered in evaluating the credibility or reliability of the CLEC proposals.²⁷ In

²⁵ MN Cost Docket, Tr. Vol. 1, May 13, 2002 (AT&T Witness Douglas Denny) pp. 94-95; “the MST [algorithm for determining cable mileage] is not a method set on . . . how you design a network in the real world”; (AT&T Witness Dean Fassett) p. 220; “[MST is] not a method that we would use in engineering”; Arizona Corporation Commission Docket No. T-0000A-00-0194 (“AZ Cost Docket”) Phase IIa; Tr. Vol. VI, July 27, 2001 (AT&T Witness Douglas Denny) pp. 1397-99; In the Matter of the Cost of the Unbundled Loop of QWEST CORPORATION, Docket No. 01-049895 (Utah PSC) (“Utah Cost Docket”), Tr. Vol. 2 (AT&T Witness Dean Fassett) pp. 248-252.

²⁶ Declaration of S. Bickley on Behalf of AT&T Corp., Qwest Communications Application for Authority to Provide In-Region, InterLATA Services in CO, ID, IA, NE and ND, WC Docket No. 02-148, July 3, 2002, ¶¶ 5-9 [redacted version]. The Bickley Declaration confirms the Commission’s doubts about the reliability of cost estimates prepared for use in regulatory proceedings, and the susceptibility of such estimates to manipulation by advocates. The purpose of the Bickley Declaration was to estimate the forward looking “internal retailing and related costs” (¶ 2) that would be incurred by an “efficient” CLEC, to support AT&T’s argument that rejection of Qwest’s application under section 271 was warranted based upon concerns about a purported “price squeeze.” In the Commission’s section 271 proceeding, AT&T’s advocacy interests were advanced by overestimating costs. Sure enough, AT&T estimated in that proceeding that forward looking retailing and customer care costs were at least \$10.00 per line per month. *Id.* ¶ 1 In contrast, the version of the HAI model submitted by AT&T for use in Washington’s UNE rate proceeding, where AT&T’s advocacy interests are served by underestimating costs, produces a monthly recurring charge for the loop of only \$6.70.

²⁷ See AZ Cost Docket, Tr. Vol. VII, July 30, 2001 (AT&T Witness Thomas Weiss) 1549; current amount and cost of ILEC directional boring not relevant. Current ILEC flow through

addition, the resale CLECs oppose disclosure and/or consideration of data sought or obtained from facilities-based CLECs that are indicative of forward looking costs, on the ground that TELRIC costs may be determined only with reference to hypothetical networks and practices.²⁸ Lacking conspicuous and unambiguous guidance from this Commission,²⁹ state commissions have frequently accepted these arguments.³⁰

rates not relevant. MN Cost Docket TR. Vol. 1, May 13, 2002 (AT&T Witness Dean Fassett) pp 204-205, 226. Current ILEC costs generally not relevant. In the Matter of the Consideration of Costing and Pricing Rules New Mexico Public Regulation Commission, Case No. 3495 Phase B (NM Cost Docket). Deposition of Timothy Gates, dated Nov. 4, 2002, pp. 34, 41, 42, 58, 59; Current ILEC costs generally not relevant; Reply Brief of MCI dated May 7, 2003 p. 10 (“the comparisons [to actual cost] offered by Qwest . . . have no relevance to validation of results of a properly constructed TELRIC model.”).

²⁸ WorldCom Inc’s Response To Qwest Motion To Compel Discovery Responses, (NM Cost Docket), December 9, 2002, at 4 (“WorldCom’s actual costs are irrelevant because the Commission must set costs based on the TELRIC standard, that is, forward looking most efficient and least cost. Neither ILEC actual costs, CLEC actual costs, nor IXC actual costs, are appropriate to use to establish TELRIC based prices”); *see also* AT&T and WorldCom’s Opposition to Qwest’s Motion to Compel Discovery, Docket UN 1025 (OR PUC), April 17, 2003 at 8; AT&T/WorldCom Responses to Qwest Motion to Compel, Docket No. UT 023003 (WUTC), August 22, 2003 at 16. CLEC data on flow-through rate for OSS and sharing not relevant. MN Cost Docket Vol. 1 (Fassett) pp. 206-7; CLEC data on flow-through rate for OSS and sharing not relevant; AZ Cost Docket TR. Vol. VII (Weiss) 1511-1512 (“now is not a forward looking time”); 1555-6, 1567-8, 1572, 1579; (Lathrop) 1254, CLEC placement costs not relevant to future placement costs (“What my [CLEC] client pays per foot to place buried plant is irrelevant to the prospect of trying to determine what the UNE costs is.”) Vol. V, July 20, 2001 (MCI Witness Roy Lathrop) 1254.

²⁹ Compare Brief of FCC at 17-18, *AT&T v. FCC*, 220 F.3d 607 (D.C. Cir. 2000) (disavowing argument that “TELRIC precludes consideration of historical costs in calculating forward-looking costs”) and *Wireline Competition Bureau VA Arbitration Order*, 18 FCC Rcd at 17741-42 ¶ 37 and n.103 (recognizing that “historic cost information” may “be probative of forward-looking costs”) with *Inputs Order*, 14 FCC Rcd at 20262 ¶ 247 (“the forward-looking practice of a carrier does not necessarily equate to the historical practice of the carrier.”).

³⁰ *See, e.g.*, In the Matter of the Determination of the Cost of the Unbundled Loop of Qwest Corporation, Docket No. 01-049-85 (UPSC), Report and Order, at 5 (“Historical costs, practices, and policies have little to do with setting TELRIC prices.”); MN Cost Docket Order ¶¶ 66-67 (adopting AT&T/WorldCom proposal for GSA costs that was equivalent to less than one-third of Qwest’s actual current costs, and failing to consider or explain discrepancy); *id.* ¶ 54 (adopting proposal to assume plant mix of 5% underground based on unverified testimony of expert, and

CLECs combine their opposition to “actual marketplace evidence” of “real world” costs or practices that might constrain their “self serving models and forecasts” with a strategy that “focus[es] on intimidating the regulators into giving you the (Bell’s) network at prices that induce entry.”³¹ Specifically, “AT&T and MCI have said that they would not enter a market/state unless the discount from retail [provides] a certain level of margin criteria.”³² When met with arguments about the potential impact of their proposals on investment incentives, the CLECs claim that efficient investment decisions and the “costing and valuation” (and hence prices) of UNEs “are entirely separate matters.”³³

The CLECs’ speculative and hypothetical “black box” approach to TELRIC, coupled with their “strategy of intimidation,” has produced an array of rate decisions that bear little relation to reality, and are consistent in only one respect: a constant ratcheting down of UNE rates to levels well below any legitimate measure of cost.³⁴ In contrast to the per-line investment

failing to acknowledge or explain evidence that Qwest’s use of the underground of method increased from 22 to 32% between 2000 and 2002); Decision No. 64922, Docket No. T00000A-00-0194 (Az Cost Docket)(AZ Corp. Commission), June 12, 2002 at 10 (refusing to consider Qwest’s actual costs).

³¹ “AT&T to Offer Local Service in 2 Major Qwest Markets,” Denver Post, Sept. 19, 2003 at C2 (quoting former chairman of Colorado Commission, Raymond Gifford).

³² Gartner, Inc., “*Unbundled Network Element Policies Threaten U.S. Telecom Services Growth*,” Oct. 24, 2003 (“Gartner Report”), at 8; *id.* (AT&T has “indicated that it required 40 to 50% gross margin before competing in a market where ILECs were not breaking even,” and “abandoned its plan” to provide UNE-platform service in Florida “because UNE prices did not meet its margin criteria”).

³³ Reply Brief of AT&T Corp., at 8-9 (filed July 23, 2001), *Verizon v. FCC*, 525 U.S. 467 (2002) (“AT&T S. Ct. Reply Br.”) (“[m]aking efficient investment decisions and the costing and valuation of assets are entirely separate matters”).

³⁴ A recent survey of national UNE prices indicates that between 2002 and July 2003, average loop and switch rates set by state commissions declined by 10.3% and 47.9%, respectively, and the average price of the UNE-Platform (including but not limited to loops and

of “about \$1000 per household incurred by providers of cable telephony”³⁵ -- a number very similar to the \$935 it costs Qwest today to add new lines to its network in urban areas -- CLECs have proposed, and state commissions have adopted, statewide average investment figures well under \$600 per-line for the purpose of determining UNE loop rates.³⁶ Total operating expenses proposed by the CLECs and adopted without adjustment by state commissions in Arizona and Minnesota allow for recovery of only 29% and 33%, respectively, of Qwest’s current actual operating expenses, as reported in ARMIS.³⁷ No CLEC witness has identified any action that Qwest, which has been operating for more than ten years under the incentives created by price cap regulation, could take to further reduce expenses from current levels, much less reduce them to the levels proposed by the CLECs. No CLEC witness has presented evidence that Qwest could function, much less provide the same level of service that it provides today, if it eliminated 70% of its workforce.

Clearly, disparities of this magnitude cannot be explained by changes in technology and market prices of labor and other inputs. Absent measures by the Commission imposing some discipline and rigor on the process for developing UNE prices, this trend will not merely

switching) declined by 17.3%. Gifford at 475 n.41, *citing* Gregg’s survey of national UNE prices.

³⁵ See “*Regulators Search for Strategies to Encourage Network Investment*,” Telecommunications Reports, TR Daily, Nov. 18, 2003 (quoting Richard Cimmerman, senior director-state policy for the National Cable and Telecommunications Association).

³⁶ Specifically, the statewide average loop investment adopted by commissions in Arizona and Minnesota using the HAI model are, respectively, \$505 and \$570 per line. Of course, the disparities between the investment per line adopted by the Arizona and Minnesota commissions based on the CLEC models, on the one hand, and the corresponding actual investment by the cable industry and Qwest on the other, is understated, for the former are statewide averages, while the latter are limited to lines in urban areas.

³⁷ AZ Cost Docket, Decision No. 64922 pp.25-26. MN Cost Docket, ALJ Recommended Order ¶¶ 65-67.

continue, but will accelerate. The most recent version of the AT&T/MCI model, HAI version 5.3, estimates investment per-line in Washington at \$366, which is about \$100 per-line lower than the figure generated by a version filed in that state's prior cost docket.³⁸ Total operating expenses generated for Washington by HAI version 5.3 are only 21% of Qwest's actual operating expenses for that state. Thus, according to the latest version of the CLECs' model, the cost of a loop in Washington is only \$6.70, in contrast to the \$11.95 estimated by the version of HAI filed by AT&T in Washington's prior cost docket.³⁹

The need for further guidance is underscored by the number and magnitude of inconsistent rate determinations by state commissions.⁴⁰ For example, in the Qwest region:

(a) The non-recurring charge ("NRC") for basic installation of a two-wire loop ordered by state commissions ranges from \$4.33 in Minnesota to \$55.27, \$53.86, \$51.94 in Colorado, Arizona and Washington, respectively.⁴¹

(b) The NRC for basic installation with performance testing of a two-wire loop ranges from \$14.42 in Minnesota to \$142.10, \$126.10 and \$117.30 in Colorado, Washington and Arizona, respectively.⁴²

³⁸ As CLECs become increasingly adept at exploiting the absence from "hypothetical" TELRIC of any meaningful constraints on their imaginations, investment per-line figures generated by succeeding versions of the HAI model have radically declined from the already low levels produced by the initial version. The three most recent versions of the HAI model, 3.1, 5.2, and 5.3 (the latest version) have generated investment per-line figures for Oregon of about \$599, \$498 and \$435, respectively. Washington and Oregon are the only two states for which AT&T/MCI have provided sufficient material to calculate investment per-line using HAI version 5.3.

³⁹ WA Cost Docket, Direct Testimony of AT&T/MCI Witness John Klick, dated Feb. 21, 1997, Ex. JCK 2.

⁴⁰ See *CO PUC Cost Docket Rehearing Order* at 12 ("based on hypothetical, efficient, future-built networks, a whole range of plausible assumptions can produce disparate results").

⁴¹ These figures are identified in Exhibit A to the SGATs filed by Qwest in each state. In Oregon the charge is \$10.75.

⁴² *Id.*

(c) The per-cable charge for a 20 amp power feed in a cageless collocation arrangement ranges from \$164 in Minnesota to \$5,300, \$4,756 and \$2,990 in Colorado, Washington and Arizona, respectively.⁴³

CLECs have likewise observed that “failure to consistently apply a single set of rules has generated tremendous variations in *recurring* UNE rates from state to state that cannot be attributed to differences in factual circumstances.”⁴⁴

For all of these reasons, Qwest strongly supports the Commission’s tentative conclusion (*Notice* ¶ 48) regarding the need to “impose[] some real-world boundaries on the UNE cost inquiry,” and ensure greater, consistency, predictability and transparency in its process and results. The nature and magnitude of inconsistent results in state proceedings, the precipitous overall decline in UNE rates, and the CLECs’ ability in the most recent version of their model to cut by *almost half* (*i.e.*, from \$11.95 to \$6.70) the loop costs generated by a prior version, without significantly changing the labor or material cost inputs, using *the same TELRIC pricing methodology*, all confirm that an “excessively hypothetical” (*id.* ¶ 7) approach to TELRIC “forecloses anything resembling a principled answer” to the UNE cost inquiry.⁴⁵ Accordingly, the Commission should require UNE prices to be based on designs, technologies and practices that have actually been deployed, and restore real-world attributes and evidentiary rigor to the UNE cost inquiry.

⁴³ *Id.*

⁴⁴ AT&T 1999 Ex Parte, “State Use of Forward Looking Economic Cost Methodologies: Some Convergence in Principle, But Not in Practice” at 20 (emphasis added); (*id.* at 21) (urging FCC to “resume its role as administrator of national policy under federal law” and “use every opportunity to explain, clarify and elaborate upon its forward-looking pricing rules”).

⁴⁵ *Gifford* at 473.

I. THE COMMISSION SHOULD “IMPOSE REAL WORLD BOUNDARIES ON THE UNE COST INQUIRY” BY CLARIFYING AND MODIFYING ITS RULES IN SEVERAL CRITICAL RESPECTS

The Commission seeks comment on a forward looking approach that sends proper price signals to CLECs whether to lease facilities or build facilities, and provides ILECs with the means and incentives to maintain and upgrade their networks. Qwest believes that the approach most likely to achieve the Commission’s goals, and promote the related goals of consistency and predictability, would be to determine prices based on the actual costs the ILEC expects to incur. The merits of such an approach are explained by Professor Weisman in the paper attached hereto.

Many of the principles espoused by Professor Weisman would also support the use of a replacement cost approach, provided that it incorporates real-world boundaries and strict evidentiary standards. As Professor Weisman explains, TELRIC costs must at a minimum reflect “objective reality” and “comport with facts on the ground.” *Weisman* at 29-34. In contrast, “models that disavow key aspects of the real world,” while tractable, are “largely meaningless.” *Id.* at 32. Objective determinations of “efficiency” should be based on comparisons of network deployment and operating practices of facilities-based carriers in the market (*id.* at 45), not speculation on behalf of parties with vested interests (*id.* at 30).

A. The Commission’s Rules Should Require Expressly That Cost Determinations Be Based Upon Network Designs, Technologies And Practices That Are Currently Used By Telecommunications Carriers, As Demonstrated By Marketplace Evidence

The most fundamental clarification necessary to achieve the Commission’s objectives is to ensure that costs are measured with reference to real-world attributes and practices of telecommunications networks today, adapted to the ILEC’s service territory. Thus, the Commission should define the forward-looking costs of providing UNEs as: (1) the investment

required to build and maintain a ubiquitous replacement network in the ILEC's service territory, assuming the use of the most efficient network designs, technologies and practices that, as demonstrated by actual marketplace evidence, are currently deployed on a scope and scale comparable to that of the ILEC, and (2) the expenses that an efficient ILEC would incur, also as demonstrated by actual marketplace evidence.

This proposed definition is consistent with forward-looking principles in general and TELRIC in particular. Since its adoption, TELRIC has required that costs be determined based on technologies, etc. that are "currently available."⁴⁶ However, the Commission has provided no guidance on how to apply the "currently available" requirement. That omission has been construed by the CLECs as a license to propose the use of models, inputs, algorithms and adjustments that bear no relationship to reality, but are entirely theoretical. In contrast, the Seventh Circuit Court of Appeals, for example, has recognized that "while TELRIC calls for a projection, it does not demand that every ingredient be hypothetical."⁴⁷

The "actually used as demonstrated by marketplace evidence" standard proposed by Qwest supplies a conclusive definition of "current availability," an issue that was addressed recently in the Bureau's arbitration of UNE prices for Virginia.⁴⁸ Qwest's approach to this issue looks to the most efficient designs, technologies and practices that have actually been deployed or used by a carrier with the size and scope similar to the ILEC.⁴⁹ Unlike AT&T/WorldCom's

⁴⁶ *Local Competition Order*, 11 FCC Rcd at 16218 adopting rule 47 C.F.R. § 51.505(b)(1).

⁴⁷ *AT&T v. Illinois Bell*, Case Nos. 03-2735 & 03-2766, *slip op.* Nov. 10, 2003 (7th Cir.) at 13 (rejecting claim that "use of actual fill factors (or asset lives matching the [ILEC's] financial reports) violates federal law because TELRIC is forward looking").

⁴⁸ *See Wireline Competition Bureau VA Arbitration Order*, 18 FCC Rcd 17722.

⁴⁹ Significantly, the Bureau acknowledged as fundamentally consistent with forward-looking principles the approach proposed by Verizon in the Virginia arbitration, which was

approach in the Virginia arbitration, Qwest's approach substitutes "marketplace evidence" of "actual deployment" for debates between consultants directed by company advocates about "theoretical feasibility." *See Weisman* at 20-21 (noting significance of actual deployment).

The limitation to technologies and systems that have actually been employed by firms "on a scope and scale comparable to that of the ILEC" is necessary to ensure that any technological, cost and other efficiencies taken into account in setting TELRIC prices can actually be implemented in practice by a company with an ILEC's size and breadth of service offerings and obligations. This is particularly critical in the area of the sophisticated network, marketing, credit management, billing and customer care systems that ILECs must install, integrate and operate. In many if not most cases, the CLECs neither operate the full range of systems used by the ILECs, nor do they need to achieve the same level of system integration required by the ILECs. Yet the CLECs frequently argue that individual systems with limited capacity or with limited inter-operability features -- that is to say, systems that are effectively useless to an ILEC -- can perform a specific task more cheaply than the relevant system employed by the ILEC. Unless a specific system or technology can be shown to be deployed and actually usable by a carrier with a scope and scale comparable to that of an ILEC, however, the "cost savings" allegedly arising from such system or technology are entirely illusory and should not be considered.⁵⁰

based on Verizon's actual network as it would exist in three years. *See, e.g., id.*, 18 FCC Rcd at 17749-50 ¶¶ 54-57, 17920-22 ¶¶ 503-08.

⁵⁰ With respect to certain issues (for example, hourly labor charges, structure sharing), the scope and scale of the carrier used for comparison are not nearly as relevant. Although there may be slight differences in costs between smaller and larger enterprises with respect to these cost categories, these variations pale in comparison to the enormous gap between the technologies and systems that can be efficiently deployed by an ILEC on the one hand, and by a smaller carrier on the other hand. Accordingly, for those new systems and technologies whose utility varies depending on the size and nature of the user's operations, the Commission should make

The approach urged by Qwest is also consistent with the Commission's preference, as set forth in the *Triennial Review Order* (§ 99), that decisions under the Act be based on "actual marketplace evidence" in lieu of "cost estimates" that are "difficult to verify" and "easily manipulated by advocates." (*Id.*) In this regard, the Commission's observation in the *Triennial Review Order* about the unreliability of "cost estimates" prepared at the direction of advocates is equally if not more pertinent to the process of setting UNE rates. First, the prospects for investment in facilities may be frustrated by unduly low prices just as easily as by requiring access to UNEs for which a showing of impairment has not been made.⁵¹ Second, as confirmed by the evolution of and results generated by the different versions of the HAI model, there is no limit on the ability of advocates to manipulate studies of the costs incurred to build and operate a hypothetical network. Thus, UNE prices, no less than determinations of impairment, should be based on marketplace evidence of real-world networks, equipment, practices and costs.

In the CLECs' view, however, evidence regarding networks, technology, practices and costs today is not even relevant to evaluate the reliability of their proposals, because it is "real" and not "hypothetical."⁵² On that basis, the CLECs argue not only that Qwest's actual costs may be ignored, but that the current costs and practices of other ILECs and facilities-based CLECs must be ignored as well.⁵³ The proposition that current costs and practices are not relevant to

clear that only those that have been deployed and can actually be used (or adapted to be used) on a scope and scale comparable to that of an ILEC will be considered in making TELRIC pricing determinations. The burden of making this showing and of identifying the relevant cost of these new systems and technologies should fall on the party proposing the use of such new system or technology.

⁵¹ See *supra* at 4-5.

⁵² See n.26 *supra*.

⁵³ See n.27 *supra*. AT&T sings an entirely different tune when defending or describing TELRIC in judicial proceedings. See, e.g., Reply Brief for Appellants, *AT&T Corp. and Covad*

TELRIC and may not be considered has been rejected by the courts, the Commission, and economists alike.⁵⁴ As the Seventh Circuit has explained, “[h]ow would one know the long-run costs of the most efficient technology without understanding the costs of today’s most efficient producers?”⁵⁵ Accordingly, the Commission should, at a minimum, state expressly that current actual costs and practices of ILECs and other facilities-based carriers are not only highly relevant, but indispensable, to any meaningful determination of TELRIC rates.⁵⁶

B. The Commission Should Adopt A Rebuttable Presumption That Costs Are To Be Determined Based On The ILEC’s Most Efficient Technologies, Designs And Practices, And Its Current Expenses

The Commission should also adopt a rebuttable presumption that the standard described in Section I.A. above is satisfied by evidence of: (1) the investment that would be required to build today a ubiquitous replacement network based on the most efficient technologies, designs and practices actually deployed by the ILEC, and (2) the expenses the ILEC currently incurs in

Communications Company v. FCC, No. 99-1538, filed Mar. 22, 2000, at 10-11 (“appellants do not dispute that it can be permissible to make TELRIC determinations by taking relevant historical purchase prices and adjusting them in light of interim changes in prices.”) (emphasis in original); Reply Brief of AT&T Corp, Supreme Court Nos. 00-590, *et al.* at 17; (arguing that TELRIC rates are based on “the best practices” of the ILECs “when they install new network elements or replace existing ones using efficient technology”).

⁵⁴ See e.g., *CO PUC Cost Docket Rehearing Order* at 30 (“[i]n order to determine what something might cost in the future, it is permissible to consider what it costs in the present. . . . It is simply disingenuous for any party to argue that historical costs are not relevant to this proceeding”); *Weisman* ¶ 33.

⁵⁵ *AT&T v. Illinois Bell*, Case Nos. 03-2735 & 03-2766, *slip op.* at 13 (7th Cir. 2003).

⁵⁶ See generally, 8th Supplemental Order, *In the matter of the Pricing, Proceeding for Interconnection Unbundled Elements, Transport and Termination and Resale*, Docket No. UT 960369-71 (“WA Cost Docket”), May 11, 1998 (WA UTC) ¶ 27, (“the inputs must be realistic accurate estimates of all of the actual costs a provider would incur if it built out a new network using the least cost forward looking technology”) ¶ 37 (“the inputs to cost models need to be validated”); *CO PUC Cost Docket Rehearing Order* at 50 (adopting actual network operating expenses less 4% productivity adjustment).

operating its network. The presumed investment and expenses would be subject to specific adjustments based on marketplace evidence of known and measurable efficiencies achieved by other carriers through actual deployment on a scope and scale comparable to that of the ILEC of other technologies, designs or practices.⁵⁷

The rebuttable presumption suggested here is supported by both Commission and judicial precedent. The Commission has approved as TELRIC compliant loop costs determined by the Georgia Commission based on a sample of BellSouth's existing loops that were redesigned to reflect forward-looking criteria, and assumed that "cable routes would follow existing rights-of-way and roads that BellSouth would use today if it were to place that cable."⁵⁸ Both the Commission and a federal court have approved as TELRIC-compliant UNE rates determined by the Texas Commission based on Southwestern Bell's "existing network routes, wire center locations and 'Texas specific data such as the costs associated with construction and rights of way that SWBT actually incurs in the laying of its network.'"⁵⁹

⁵⁷ Of course, adjustment would be warranted only if: (1) the alternative technology or practice, etc., could be deployed by a firm with the scope and scale of the ILEC, and (2) the costs of deploying the alternative were supported by actual market evidence and included in the appropriate UNE rates.

⁵⁸ Memorandum Opinion and Order, *Joint Application by BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc. for Provision of In-Region, InterLATA Services in Georgia and Louisiana*, 17 FCC Rcd 9018, 9039-40 ¶ 36 (2002).

⁵⁹ *SWBT v. AT&T*, 1998 U.S. Dist. LEXIS 15367 (W.D. Tex. 1998) at 21, quoting TPUC Arbitration Award at 62. See Memorandum Opinion and Order, *Application by SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance*, 15 FCC Rcd 18354, 18394-95 ¶ 89 (finding that UNE rates established by Texas commission complied with TELRIC). Although the Commission's pricing rules had been stayed at the time of the arbitration award affirmed in *SWBT v. AT&T*, the Texas Commission "independently adopted the TELRIC methodology for establishing rates to be set for network elements." U.S. Dist. LEXIS 15367 at 20.

In addition, the focus of the presumption suggested by Qwest is not “reproduction” costs, but “replacement” costs. That is, the presumed investment would be based on that required to replace the *entire* network with another one that uses throughout the most efficient technologies the ILEC has successfully deployed. CLECs could not legitimately object to such a presumption, for they have agreed that ILEC networks contain not only older technologies, but also “the latest generally available new technologies.”⁶⁰ Indeed, AT&T represented to the Supreme Court that TELRIC rates are based on “*the best practices*” of the ILECs “*when they install new network elements or replace existing ones using efficient technology.*”⁶¹ Consistent with AT&T’s argument to the Supreme Court, both investment and expenses should be based on the “best practices” of the ILECs, rather than merely assuming, without supporting evidence, 80% reductions or more in the actual expenses incurred under those practices.

Under Qwest’s approach, moreover, each presumed element of investment and expenses would be subject to rebuttal based on marketplace evidence of actual deployment of more efficient technologies and practices, and the resulting savings relative to the ILEC’s costs. Thus, CLECs would be free to provide marketplace evidence that a different carrier, for example, has deployed on a scope and scale comparable to that of the ILEC a more efficient technology, and the savings it has achieved. No aspect of the ILEC’s actual costs would be conclusive.

Finally, the rebuttable presumption suggested by Qwest is warranted by the fact that ILECs have for well over a decade been operating under price caps and other forms of incentive

⁶⁰ Brief for AT&T at 4 (filed April 9, 2001), *Verizon v. FCC*, *supra*.

⁶¹ AT&T S. Ct. Reply Br. at 17 (emphasis added). Similarly, the Commissions’ briefs to the Supreme Court emphasized that costs as determined under TELRIC are based on “equipment that carriers are *already using* to upgrade and expand their networks.” Reply Brief for Petitioners United States and the Federal Communications Commission, filed July 2001 at 6, *Verizon v. FCC*, *supra* (emphasis added).

regulation at the federal level and in the vast majority of states.⁶² Both the Commission and the Supreme Court have recognized that price cap regulation “give[s] companies an incentive to improve productivity to the maximum extent possible.”⁶³ Specifically, price caps creates incentives to: (1) operate with the least cost technology, (2) operate with no waste, (3) undertake efficient levels of cost-reducing innovation, and (4) report costs truthfully. *See Weisman* ¶ 36. The data confirm that carriers have responded to these incentives.⁶⁴ For these reasons, the Bureau has observed that “actual recent experiences” of an ILEC operating under price caps during the period for which data has been collected “may be particularly probative” of forward-looking costs.⁶⁵

C. The Commission Should Reaffirm That TELRIC Is To Be Determined With Reference To Current Constraints And Other Conditions External To The Network

The principle that the relevant costs are those that would be incurred in designing and building a replacement network *today* requires assumptions that differ from embedded configurations and costs in several respects. For example, the immediate deployment of a ubiquitous replacement network would result in significant economies that are not available

⁶² *See Weisman* at 18-22. Qwest is currently deregulated or subject to price cap regulation in eleven and a half of the 14 states in which it operates as an ILEC. Idaho has deregulated half the state. In Washington, Qwest is operating under a rate moratorium that duplicates most of the incentives of price cap regulation. The only state in which Qwest is subject to full rate of return regulation is Montana. No state requires that earnings be shared.

⁶³ *Verizon v. FCC*, 535 U.S. 467, 487 (2002), *quoting Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, 6787-88 (1990).

⁶⁴ *See, e.g., J. Abel, “The Performance of the State Telecommunications Industry Under Price Cap Regulation: An Assessment of the Empirical Evidence,”* NRRI 00-14, National Regulatory Research Institute, Sept. 2000. Between 2000 and the end of 2002, the BOCs shed a total of 104,750 jobs. ALTS, *The State of Local Competition* 2003 at 12.

⁶⁵ *Wireline Competition Bureau VA Arbitration Order*, 18 FCC Rcd at 17832-33 ¶ 285.

when a network is deployed over time. Specifically, in a replacement network, all demand can be met with one appropriately-sized cable, eliminating the need to incur multiple placement costs as cable routes are reinforced to meet growing demand. In addition, serving areas may be designed to optimize the placement of lower cost, more efficient electronics. Conversely, building a replacement network today may require expenditures that were not required when the ILECs' networks were first built. For example, the builders of the replacement network would incur costs to place facilities in paved and landscaped areas that have been developed since the ILECs' networks were first built, and without sharing such costs with other utilities with facilities that already had been deployed.

Nevertheless, CLECs have argued to state commissions, in many cases successfully, that it is permissible to base TELRIC determinations on embedded conditions whenever doing so will result in costs that are lower than those that would be incurred as a result of conditions prevailing today. In addition to arguing that inputs for structure sharing and placement methods should be based on conditions as they existed at the time the ILEC's network was first built,⁶⁶ the CLECs have also argued that TELRIC assumes not only that the ILEC operates in an efficient manner, but that CLECs do so as well.⁶⁷ On that basis, they have convinced state commissions in Arizona

⁶⁶ See AZ Cost Docket Response of AT&T and XO to Exceptions ("Response"), at 13-14 (noting that the HAI model assumes that buried cable would be placed in the reconstructed network "before structures such as roads and landscaping are in place," and criticizing Qwest's model because it assumes, "by contrast" with the HAI model, "all physical structures are currently in places they are today").

⁶⁷ See Response To Plaintiff's Opening Brief of Intervenor/Defendants AT&T Communications and MCI WorldCom ("AT&T/MCI AZ Appeal Br."), *Qwest v. Arizona Corporation Commission*, No. CIV 02-1626 PHX SRB, filed Feb. 28, 2003 at 48 n.57 (arguing that flow-through rate of 98% is reasonable notwithstanding undisputed evidence that 26% of CLEC orders are submitted by fax because TELRIC requires the assumption that CLECs are more "technologically advanced"). The CLECs have been unable to identify any ILEC that has been able to achieve a 98% flow-through rate for all UNEs: AZ Cost Docket, Tr. Vol VII, July 30, 2001 (AT&T Witness Thomas Weiss) at 1511; NM Cost Docket Staff Ex. 13 (Morrison

and Minnesota to adopt flow-through rates that “assume away” the substantial percentages of orders that are faxed by CLECs and thus require some manual processing by ILECs. In addition to distorting the economic signals that TELRIC is supposed to send, UNE prices reflecting this assumption reduce the incentives of CLECs to become more efficient, and actually reward CLECs for inefficiencies by having the associated costs borne by their competitors, the ILECs.

These arguments should never have been made to, much less accepted by, state commissions, in light of this Commission’s statements in the *Local Competition Order* about the objectives and proper application of TELRIC, and the description of TELRIC provided by the Commission to the Supreme Court.⁶⁸ The *Notice* (§ 47) finally puts this controversy to rest -- albeit seven years later -- by confirming that TELRIC is violated by a proposal that “assumes away . . . [the] attributes of the real world in which incumbents and competitors operate.” To prevent the reoccurrence of these and similar distortions of TELRIC, the Commission should reaffirm expressly that the determination of forward-looking costs of a ubiquitously-deployed replacement network must: (1) fully account for those aspects in which costs may be higher relative to a historic or embedded methodology, as well as those aspects in which costs may be lower; and (2) be based on conditions external to the network as they exist today (*e.g.*, may not reflect a greater or lesser amount of undeveloped, “growth” or “greenfield” areas than actually exists today).

Deposition, Nov. 4, 2002) at 70-74; MN Cost Docket, Tr. Vol. 1, May 13, 2002 (AT&T Witness Thomas Weiss) p. 206.

⁶⁸ See Brief for Petitioners United States and the Federal Communications Commission, Supreme Court Nos. 00-590, *et al.*, filed July 2001.

D. The Commission Should Clarify That Its UNE Pricing Rules Require The Use Of Consistent Models, Inputs And Assumptions

In the *Triennial Review Order*, the Commission confirmed that state commissions are required to “use a consistent set of assumptions when they calculate the three components of rates (operating expenses, cost of capital, and depreciation expense).”⁶⁹ In the *Notice* (¶ 117), the Commission again emphasizes that “consistency among the various components of rates is important,” and explains that “[u]sing one set of network assumptions for recurring charges and a different set of network assumptions for NRCs potentially results in some over-recovery or under-recovery.” The Bureau, moreover, has required the use of consistent assumptions for loop plant and switching.⁷⁰

Notwithstanding this authority, CLECs continue to advocate the use of inconsistent models and assumptions whenever doing so would support further reductions in UNE rates. For example:

(a) Although CLECs propose *de minimis* NRCs on the ground that the use of manual labor can be eliminated for most activities by the use of automated systems (including some that exist only in their imaginations), they have proposed, and state commissions have adopted, costs for “general purpose computers” that are less than 25% those currently incurred by Qwest. The CLECs offer, and state commissions require, no reconciliation of these patently inconsistent assumptions.

(b) The CLECs’ proposals for *de minimis* NRCs also assume that lines terminating at unoccupied premises (*e.g.*, vacant houses awaiting occupancy by new owners) remain connected to the switch, eliminating the costs associated with manual

⁶⁹ *Notice* ¶ 84, citing *Triennial Review Order* ¶¶ 682, 689.

⁷⁰ *Wireline Competition Bureau VA Arbitration Order*, 18 FCC Rcd at 17889 ¶ 426.

cross-connect activities that would otherwise be required to disconnect the line when the premises are first vacated, and to reconnect the line when a new customer moves in. However, leaving idle lines connected decreases the fill on the switch by dedicating inactive ports to vacant premises. The CLECs' proposed recurring charges for switching do not account for the extra capacity needed to allow for dedicated lines to vacant premises, as assumed by their proposed NRCs.⁷¹

(c) The Arizona commission adopted inconsistent assumptions with respect to placement methods and sharing. Specifically, after assuming an excess amount of the least expensive method of placement, plowing, the Arizona commission then artificially reduced placement costs even further by assuming that the costs of plowing would be shared with at least one other utility.⁷² These assumptions are inconsistent, in light of unrefuted testimony of an AT&T witness in the same proceeding that structure sharing would not occur for cable placed by plowing.⁷³

The Commission should thus require the use of assumptions that are consistent within the three components of costs, as well as within elements, across elements, and across recurring and nonrecurring charges.⁷⁴ The Commission should also prohibit the reduction of cost estimates

⁷¹ AZ Cost Docket, Tr. Vol VII, July 30, 2001 (AT&T Witness Dean Fassett) at 1568-70; NM Cost Docket, Staff Ex. 13 (Morrison Deposition) at 68-70.

⁷² *Arizona Cost Docket Order* at 14.

⁷³ AZ Cost Docket, Tr. Vol VI, July 27, 2001 (AT&T Witness Douglas Denny) at 1424.

⁷⁴ The consistency "principle" should continue to "apply" under the approach to the determination of replacement costs urged by Qwest. *See Notice* ¶ 84. In particular, all inputs under Qwest's approach assume a market characterized by "widespread facilities-based competition." The only difference between Qwest's approach and the CLECs' approach is that costs must be determined with reference to actual marketplace evidence in lieu of speculation about the theoretical feasibility of hypothetical networks.

based on the assumed deployment of an advanced technology or system that has not been identified with specificity, or for which the costs have not been included in the appropriate UNE rates.

- E. The Commission Should Codify In Part 51 Of Its Rules The Requirements That Proposed Cost Models And Inputs Be: (1) Explained With Specificity, (2) Transparent, And (3) Verifiable.

In the *Local Competition Order*, the Commission required that TELRIC studies “explain with specificity . . . how the associated costs were developed.”⁷⁵ The Commission now seeks comment on the “importance of transparency and verifiability” in achieving the Commission’s investment and cost recovery goals. (*Notice* ¶ 41.) Qwest believes that transparency and verifiability are critically important to the determination of costs,⁷⁶ and urges the Commission to underscore their importance by codifying these requirements in Part 51 of its rules.

The *Notice* (¶ 60) has it backwards, however, by suggesting that deviation from the “excessively hypothetical” approach to TELRIC in favor of one that recognizes “real-world boundaries” “raises issues of transparency and reliability.” By definition, something that is merely hypothetical cannot be verified.⁷⁷ As Professor Weisman explains:

What renders a rate methodology or costing standard untenable is not the use of predictive judgment *per se*, but rather the use of predictive judgment that has little or no foundation in reality, or cannot be validated or verified. Differences in degree can shade into differences in kind when predictive judgment degenerates

⁷⁵ *Local Competition Order*, 11 FCC Rcd at 15850-51 ¶ 691.

⁷⁶ Preliminarily, Qwest believes that the requirements of transparency and verifiability have always been inherent in the Commission’s rules, and those should not be regarded as “new.” *See Wireline Competition Bureau VA Arbitration Order*, 18 FCC Rcd at 17747 ¶ 48. Otherwise, the “specific explanation” that the Commission had expressly required in adopting TELRIC could not be confirmed through sources other than the proponent.

⁷⁷ Efforts to verify the information used by the CLECs other than that contained in the imaginations of their consultants and witnesses are frequently hindered by claims that the information is proprietary to the CLECs or their consultants. *See infra* at 62-64.

into wild speculation. Predicting how fast an Olympic sprinter will cover one-hundred meters in the next race on the basis of his performance in the last ten races is predictive judgment; predicting that this very same sprinter could cut his time in half in the next one-hundred meter race if only he wore new shoes is wild speculation. (*Weisman* at 15.)

The absence of transparency and verifiability of proposals based on speculation about hypothetical networks has in fact resulted in rates that differ “in kind” rather than “any degree” (e.g., expenses proposed to be recovered in UNE rates less than 20% of actual expenses; loop rates that are cut in half from one version of the HAI model to a succeeding version), as predicted by Professor Weisman.

The lack of transparency and verifiability under the “excessively hypothetical” version of TELRIC is starkly illustrated by the model (“HAI Adjunct Model”) that the CLECs propose for use in determining the costs of high-capacity loops. In the Minnesota commission’s UNE cost docket, neither the HAI Adjunct Model, HAI version 5.2a nor any other documentation or testimony submitted by the CLEC sponsors of the models identified the prices of the necessary multiplexing and terminating equipment that were purportedly included in the CLECs’ proposal. Rather, the CLECs mainly provided only aggregated “investment per-line” figures, apparently reflecting a blend of equipment prices and other costs, not the individual components of the investment figures.⁷⁸ Thus, the HAI Adjunct Model was not “transparent.”

Nor was the HAI Adjunct Model “verifiable.” In the Minnesota proceeding, AT&T/MCI provided no documentation or other information that would permit “verification” of the accuracy of the assumed equipment prices -- had they been identified. The CLECs’ witness on the HAI Adjunct Model could not even say whether any “price lists or invoices” were used or consulted

⁷⁸ MN Cost Docket Hearing, Tr. Vol. 1, May 13, 2002, at 63-74 (AT&T Witness Douglas Denney cross-examination); Hearing Ex. 241 (Qwest Witness Robert Brigham Rebuttal Testimony) at 4-10.

in determining the equipment prices.⁷⁹ Nor could the witness identify which, if any, equipment vendors or CLECs were contacted for pricing information, or even the year of such contacts.⁸⁰

Another example is the CLEC models and proposals for NRCs. In Minnesota and elsewhere, CLECs have provided only the vaguest explanations of how they arrived at their proposals, and no information that would permit verification of their accuracy or reliability. Thus, for example, in the words of the Minnesota commission, AT&T and MCI provided no “work papers supporting [their] assumption that certain costs could be recovered through a recurring charge or of its time estimates and probabilities of certain work activities occurring,” but merely “indicated” that the assumptions were “based on the professional judgment of experts.”⁸¹ The Minnesota commission nevertheless adopted the assumptions. *Id.*

By contrast to the CLECs’ proposed hypothetical costs, the ILEC’s “actual costs can be audited and validated (or otherwise) because these costs reflect the attributes and operating characteristics of networks that actually exist.” *Weisman* at 23. Information about the ILEC’s existing network, practices and expenses are available from either public sources or the ILEC in response to discovery requests. Moreover, these costs can be compared to those of similarly situated ILECs (*id.*) and, except where the validity of the comparison may be impacted by differences in scope and scale, to the actual costs incurred by facilities-based CLECs. Finally,

⁷⁹ MN Cost Docket Hearing, Tr. Vol. 1 (AT&T Witness Douglas Denney cross-examination) at 64.

⁸⁰ *Id.* at 66-67 (AT&T witness testifies “there are no price lists, no invoices, no identification of a vendor from whom we can buy” the equipment); *id.* at 68, lines 17-20 (AT&T witness testifies that the parties “have no way of going to those data CLECs [with whom the developers of the Adjunct Model allegedly held discussions] to find out what information they provided”); *id.* at 72, lines 3-8 (AT&T witness testifies that he does not know the identity of the data CLECs consulted by the model’s developers, or the year in which the alleged discussions occurred).

⁸¹ *MN Cost Docket Order* ¶ 278.

concerns about any information asymmetries that may exist with the ILEC's actual costs are easily outweighed by the virtual complete absence of information underlying, and verifiability of, the speculative conclusions of advocate-directed subject matter "experts."⁸² *Id.*

II. NETWORK AND OTHER ASSUMPTIONS

Part I above set forth the most fundamental respects in which TELRIC should be clarified and/or modified. Part II below illustrates and supplements these proposals in the context of particular types of costs, inputs, assumptions and charges.

A. Network Assumptions

For the reasons described below, Qwest supports the Commission's tentative conclusion that its "TELRIC rules should more closely account for the real-world attributes of the routing and topography of an incumbent's network in the development of forward-looking economic costs" (*Notice* ¶ 52).

1. Network Routing

Network routing affects, among other things, the amount of cable mileage within the network. In designing and routing a network, engineers must consider natural obstacles such as mountains, lakes and rivers. In addition, engineers must consider the availability and costs of obtaining access to rights-of-way through which networks are routed. Acting on their obvious incentives to artificially reduce costs by limiting cable mileage, and the absence of any countervailing incentive to estimate mileage accurately, the UNE-P CLECs propose models and

⁸² Non-public information about or relevant to the costs incurred today by facilities-based carriers is clearly relevant to forward-looking costs, and its exclusion would preclude the compilation of a complete and accurate record. The Commission should address concerns about the availability of non-public information, and its proprietary nature, by issuing binding guidelines addressed to discovery and protection of non-public information, as discussed *infra* at 63-64. The exclusion of relevant evidence based on concerns that may be addressed through discovery and other requirements would be an extraordinary departure from standard practice.

algorithms to develop “least cost routing” calculations that assume that cable may be placed anywhere, with little regard for natural obstacles, and no regard at all for the location of existing rights-of-way or the availability of alternative ones. As described by one state commission, the CLEC proposals are “based on abstract mathematics” and “abandon entirely the real world in favor of the hypothetical.”⁸³ Yet other state commissions have adopted them.⁸⁴

The CLECs themselves readily admit that “they would not use [their proposed algorithms] to engineer actual telephone distribution plant.”⁸⁵ They nevertheless defend their proposals before state commissions and federal courts by claiming that “[w]hether [a] model uses as a starting point ‘engineering principles’” is “irrelevant” under the “FCC’s TELRIC rules,” provided its proponents can find a mathematician willing to endorse it.⁸⁶ They also assert, without empirical validation, that any understatement in cable mileage resulting from the failure to account for obstacles and rights-of-way is offset by alleged overstatements resulting from other aspects (*e.g.*, “right-angle routing”) of their plant design.⁸⁷

These arguments epitomize the fundamental flaws in the CLECs’ interpretation and application of TELRIC. If the purpose of the Commission’s pricing rules is to send the proper signals for investment, then it is essential that costs be determined under a methodology that is

⁸³ *MN Cost Docket Order* at 7-8.

⁸⁴ *See AZ Cost Docket Order* at 21.

⁸⁵ *See MN Cost Docket Decision* at 7 (Minn. Pub. Utils. Comm’n, Oct. 2, 2002) (“Even MST proponents acknowledge that MST is not a method they would use to engineer actual telephone distribution plant.”).

⁸⁶ *See AT&T/MCI AZ Appeal Br.* at 36.

⁸⁷ *Id.* at 36-37. *And see, MCI v. FCC*, 842 F.2d 1296 (D.C. Cir. 1988) (remanding to Commission determination that discrimination was “reasonable,” on ground that Commission had not first identified the disparity between rates for Shared Network Facilities Agreements (“SNFA”) and “like” special access services.

actually used by the engineers responsible for building a real-world network and justifying the concomitant investment to executives and investors. Conversely, any “theoretical” (*Notice* ¶ 63) standard that does not account for limitations on the availability of alternative rights-of-way, for example, would defeat the Commission’s objectives. Accordingly, like the Washington commission,⁸⁸ for example, this Commission should require that the network routing used to determine cable mileage and other inputs be based on sound engineering practices that would account for real world obstacles and the need to obtain access to rights of way, and prohibit the use of alternative routing schemes that do not adhere to generally accepted methods and principles of network engineering and design.

2. Structure Sharing

“Structure sharing” refers to the placement of transmission facilities by multiple firms (including developers), each of which bears a *pro rata* share of placement costs, which comprise a substantial portion of loop costs. Only the share of costs borne by the reconstructed network are included in UNE rates.

To artificially reduce UNE costs and rates, the CLECs assume that as a result of structure sharing, the ILEC will bear only 33% of the cost of placing buried distribution cable.⁸⁹ This is the equivalent of assuming that *every* time a carrier incurs the significant costs of digging a trench to lay its cable, *two additional* entities will appear on the scene and agree to cover the

⁸⁸ WA Cost Docket, 8th Supplemental Order, Docket No. UT-9603669 (“WA UTC”), May 11, 1998 ¶¶ 227, 240.

⁸⁹ See, e.g., Surrebuttal Testimony of Douglas Denny on behalf of AT&T, Docket No. 01-049-85 (UT PUC), filed Nov. 11, 2002, Exh. DKD 12 (user adjustable inputs tab).

remaining 66%.⁹⁰ This assumption, described by one state commission as “fanciful,” is based on a further “aggressive” assumption, incorporated in “the HAI Model” and in “other states’ TELRIC prices,” that “the carrier will have the same opportunity in its placement of cable (*e.g.* opportunities to share placement costs with other utilities) as when the existing outside plant was constructed.”⁹¹ When this assumption has been challenged, the CLECs, in addition to defending their approach, procure “expert” opinions, unsupported by documentation or other data, that their structure sharing assumptions are reasonable even as of today. The CLECs’ attempts to justify their proposals based on conditions as they existed decades ago violate TELRIC principles, and their belated claims that their assumption are accurate even under conditions as they exist today are factually preposterous.

First, the statement in the *Notice* (¶ 72) that the approach discussed in the preceding paragraph is “backward-looking” and “erroneous[]” under TELRIC applies to structure sharing no less than to “other inputs.” As applied to structure sharing, the CLEC approach assumes that today’s real estate developments were first under construction, when a “significant amount of developer-provided trench” was supposedly available, and when “other utilities were not already in place.”⁹² The present day reality, however, is that in virtually all of the places where CLECs wish to lease loops, a carrier seeking to build a replacement network would enjoy few, if any, sharing opportunities because development in those places was completed many years ago.⁹³

⁹⁰ The sharing percentages adopted by state commissions are closer to 50%, which is likewise far in excess of the percentage that would be consistent with TELRIC principles, as discussed below.

⁹¹ *CO PUC Cost Docket Rehearing Order* at 30-31.

⁹² *AZ Cost Docket Phase IIa Order* at 13-14.

⁹³ See *Wireline Competition Bureau VA Arbitration Order*, 18 FCC Rcd at 17832-33 ¶ 285 (“[n]ew growth developments, by definition, would have significantly higher sharing

Second, even in undeveloped areas, actual marketplace evidence demonstrates that the amount of structure sharing is nowhere close to that assumed by the CLEC models and endorsed by their experts. Between 1998 and 2001, inclusive, the amount of structure sharing experienced by Qwest, including in undeveloped areas, averaged only 22%. Structure sharing figures for the CLECs are dramatically lower than those assumed by their models in UNE cost dockets. Counsel for AT&T Broadband has stated, for example, that the company “doesn’t have an opportunity to share our facilities.”⁹⁴

Accordingly, for the reasons set forth above, the Commission should: (1) reaffirm that structure sharing inputs must be based on replacement of the network under conditions as they exist today, (2) require that structure sharing inputs be based on actual marketplace evidence that occurs in developed and undeveloped (*i.e.*, “greenfield”) areas, and (3) establish a rebuttable presumption in favor of using the ILEC’s actual structure sharing percentages in developed and undeveloped areas, subject to adjustment based on actual marketplace evidence of the extent of structure sharing, if any, by other ILECs and/or CLECs.

3. Plant Mix and Placement

A critical assumption in developing the costs of loops under the Commission’s pricing rules is the relative amount of cable placed above and below the surface (“plant mix”). “Aerial” (running lines along telephone poles) cable, which requires little excavation and no restoration, is

opportunities than would exist in reconstructing the entire network”). When Qwest has been permitted to seek discovery from facilities-based carriers, the results confirm that little if any structure sharing occurs in already developed areas. Qwest is unable to share these data with the Commission, which are subject to protective orders, because the CLECs have refused to consent to Qwest’s request that they permit their inclusion in a non-public version of these comments. Other than to hide these data from the Commission, there is no reason for the CLECs’ refusals to consent to Qwest’s requests.

⁹⁴ Transcript, Hearing on Motions, Docket No. 01-049-85 (Utah Public Utilities Commission), at 23. *See also* n.93, *supra*.

generally much less expensive than cable placed below the surface.⁹⁵ However, as a result of objections by municipalities and property owners on aesthetic and other grounds, the relative amount of cable placed on aerial facilities is declining, with a corresponding increase in underground placement. Notwithstanding this “real-world” evidence, the HAI model assumes that the relative amount of aerial cable is increasing, and underground cable is declining, as explained below.

“Placement” refers to the construction method used to install below the surface loops and other transmission facilities. On a continuum from least to most expensive placement methods, the least expensive method is “plowing,” which involves using an auger to crease the ground and lay the cable in a single combined motion. Next is simple “trenching,” or digging a trench through soil, laying the cable, and re-covering the trench with the soil that had been removed. Plowing and trenching are the most efficient methods for laying cable in undeveloped areas where pavement and other obstacles do not exist. The more expensive placement methods are “boring” and “cut and restore.” “Boring” involves drilling a hole under the surface through which cable may be passed, avoiding the need for extensive surface restoration. “Cut and restore” involves digging up pavement or other obstacles, laying the cable, and restoring the surface to its original condition. “Boring” and “cut and restore,” though more expensive, are necessary in developed areas, where the surface is paved or landscaped, for example.

To artificially reduce costs of the hypothetical network, the CLEC proposals in UNE rate proceedings routinely overstate both the relative percentage of aerial cable, and the use of less expensive methods of placing cable under the surface (*i.e.*, plowing and trenching).

Correspondingly, the CLECs have routinely understated the relative percentage of cable placed

⁹⁵ In addition, there are significantly greater opportunities to share aerial facilities, which can be accessed at any time, and not only when the facilities are initially placed.

underground, and use of the more expensive methods (*e.g.*, “boring,” “cut and restore”).⁹⁶

Specifically, CLECs rely on the “time machine” approach and conclusory assertions of “expert” witnesses to support their placement assumptions in addition to their sharing assumptions.

CLECs submit no “actual marketplace evidence” of the relative use by facilities-based carriers of the different placement methods. Nevertheless, the CLEC proposals have been adopted by state commissions.⁹⁷

Accordingly, for the reasons set forth above, the Commission should: (1) reaffirm that plant mix and placement determinations must be based on replacement of the network under conditions as they exist today (*Notice* ¶ 47), (2) require that these determinations be made (a) for both developed and undeveloped (*i.e.*, “greenfield”) areas (b) based on “actual marketplace evidence,” and (3) establish a rebuttable presumption in favor of using the ILEC’s actual plant mix and placement percentages in developed and undeveloped areas. The presumptions would be subject to adjustment based on actual market evidence of plant mix of and placement methods used by other ILECs and/or CLECs.

4. Technology and Process Assumptions

Consistent with Qwest’s overall approach, the Commission should require that costs of UNEs be based on the most efficient technologies that are currently deployed on a scope and scale comparable to that of the ILEC, as demonstrated by actual marketplace evidence. State commissions should not be asked to serve as referees of debates between advocate-directed

⁹⁶ For example, the version of HAI model filed by the CLECs in Utah assumes 29.2% aerial, 66.4% buried and 4.5% underground (which is more costly than buried), compared to Qwest’s actual percentages of 14.5%, 65.6% and 19.9%, respectively. Rebuttal Testimony of William Fitzsimmons on behalf of Qwest, Docket No. 01-049-85 (Utah Public Utilities Commission), August 16, 2002, at 30.

⁹⁷ *See, e.g., AZ Cost Docket Order* at 12, n.73.

consultants about the theoretical feasibility of technologies that might be incorporated in hypothetical networks of the future.⁹⁸

Under this approach, cost determinations would be based on the use throughout the network of the most efficiently telecommunications technology deployed by the industry.⁹⁹ It is therefore a “replacement” as opposed to a “reproduction” cost approach. As such, questions (*Notice* ¶ 69) regarding the impact on technology assumptions of not assuming the ubiquitous and instantaneous deployment of new technology, or the pricing of equipment that is no longer widely used, do not arise. The only difference from the CLECs’ approach is that Qwest’s requires actual marketplace evidence of current and successful deployment in telecommunications networks,¹⁰⁰ consistent with the Commission’s stated preference in the *Triennial Review Order*.

In addition, and likewise consistent with Qwest’s proposed approach, the Commission should establish a rebuttable presumption that costs should be based on the most efficient technologies actually deployed in the ILEC’s network. The presumption could be rebutted by market evidence of deployment on a scope and scale comparable to that of the ILEC of alternative (including upgraded) technologies that are more efficient, the costs of these alternatives, and the savings they have achieved relative to the ILEC technology they would

⁹⁸ Forecasting new technologies is notoriously difficult, as evidenced by AT&T’s inability to launch the “picturephone” product it predicted to be imminent throughout the last third of the twentieth century.

⁹⁹ Adjustment would be warranted if: (1) the alternative technology or practice, etc. had been deployed by a firm with the scope and scale of the ILEC, and (2) the costs of deploying the alternative were supported by actual market evidence and included in the appropriate UNE rates.

¹⁰⁰ See *Weisman* at 14-16 (“costs must have objective reality in the sense that TELRIC measures should comport with the facts on the ground”).

replace. In addition, the costs of obtaining and deploying the alternative technologies must be provided for in the rates for the applicable UNEs.

5. Fill Factors

A “fill factor” reflects the percentage of a facility’s capacity that, on average, is used when the facility is efficiently deployed. The higher the fill factor, the lower the UNE rate, because the costs of spare capacity allocated to each unit of demand are lower. Fill factors are a critical input for a wide variety of network elements ranging from switching to loop distribution facilities to high-capacity circuits such as dedicated transport and DS1 or DS3 loops.

CLECs have proposed unrealistically high fill factors for all such elements within a replacement network capable of providing services that are at least equal in quality and reliability to those provided by the existing network. For example, the HAI model assumes a 94% fill factor for switching,¹⁰¹ even though that would include only enough spare capacity to accommodate the need for “administrative fill” (*i.e.*, enough excess capacity to operate the switch day-to-day), and none to accommodate the new lines that an efficient carrier would need to meet the inevitable growth in demand.¹⁰² Similarly, the CLECs have routinely proposed fill factors of 85% or higher for all high-capacity loops and transport facilities.¹⁰³ These proposed

¹⁰¹ HAI Consulting, Inc., *HAI Model Release 5.0 Inputs Portfolio 75* (Jan. 27, 1998) <<http://www.hainc.com/hminputs.pdf>>. This exceeds even the SM’s very high 94% fill factor for switching. *Inputs Order*, 14 FCC Rcd at 20296 ¶ 330; *see also* Tenth Supplemental Order, *In re Determining Costs for Universal Service*, Docket No. UT-980311(a) (WUTC), Nov. 20, 1998 (noting AT&T’s proposal to use the HAI default fill factor of 98%).

¹⁰² *See, e.g., AT&T v. Illinois Bell*, Case Nos. 03-2735 & 03-2766, *slip op.* at 3 (“[a]ny sensible carrier builds more network capacity that can be used at the moment; that way, capacity will be available as additional customers demand service”).

¹⁰³ *See generally* HAI Consulting, Inc., at 89 (default transport terminal fill factor of 90%); Response Testimony of Thomas H. Weiss on behalf of AT&T, Docket No. UT-003013 (Part B)(WUTC), Oct. 23, 2000, at 12 (fill of 85% for high-capacity loops).

fill factors are often supported by little more than a reference to the fill factors used by the Synthesis Model (“SM”) (*see infra* 66-68), or conclusory assertions of “reasonableness” by “experts” directed by advocates. These aggressive fill factor assumptions are flawed for the same basic reasons: (1) capacity is “lumpy” (*i.e.*, the lowest cost alternative for meeting demand is not always the one results in the lowest fill) and equipment available on the market increases in capacity only in large increments; (2) in planning and constructing their networks, efficient carriers include ample room for future growth, (3) they fail to account for lines and capacity dedicated to premises that are “vacant”, and (4) they fail to account for competitive losses to other facilities-based carriers. Each of these factors is described below.

“Lumpy” Capacity. One key reason why fill factors cannot realistically approach 100% is that capacity is “lumpy”; *i.e.*, much of the equipment available on the market increases in capacity only in large increments that do not correspond to the amounts of demand at given locations. Ground transportation provides a simple illustration of this point. Suppose that a trucking company must choose between vans and trucks as the vehicles for carrying cargo across the country. One truck has ten times the cargo capacity of a van, but the truck costs three times as much to operate. An economically efficient firm would substitute a truck for vans once the total cargo exceeds the capacity of three vans, because the truck is less costly to send across the country than three vans. Note, however, that the total “fill” or utilization of the truck at that point is 30%. If the operator’s primary objective were simply to achieve a utilization level of 85%, he would continue to use vans until he had enough cargo (*i.e.*, 9 vans). But that would be economically irrational. At a capacity of 8 vans, the operator would be spending nearly three times the amount it would cost if he had simply used the truck and “wasted” some capacity.

The telecommunications world is no different.¹⁰⁴ High-capacity loops, for example, typically come in one of two sizes: DS1s or DS3s. A DS1 circuit is the equivalent of 24 DS0s, and a DS3 is the equivalent of 28 DS1s or 672 DS0s. Because of the efficiencies associated with manufacturing and deploying equipment in standardized capacity increments, no one manufactures the electronics needed for individual circuits with capacities falling *between* a DS1 and a DS3. An end user (or CLEC) that requires a high-capacity loop therefore cannot typically purchase a single circuit with a capacity that exactly matches its particular needs, especially if the end user requires more capacity than a DS1 but less than a DS3. For example, because a DS3 is less than 28 times as expensive as a DS1 (even though it has 28 times the capacity), if a customer needs 10 DS1s, it will be less expensive to purchase one DS3 loop than 10 DS1s, even though the resulting fill factor for that facility would be low (roughly 40%). In other words, the per-unit costs of using high-capacity equipment with moderate fill levels are lower than those incurred by using low-capacity equipment with higher fills.¹⁰⁵ The resale CLECs' proposed fill factors ignore this fact.

¹⁰⁴ See *AT&T v. Illinois Bell*, slip op. at 3 (“many kinds of telecommunications equipment have minimum efficient sizes; a switch able to handle 100,000 circuits may be cheaper than two switches able to handle 50,000 circuits apiece”).

¹⁰⁵ A further illustration of this phenomenon is provided in the charts attached hereto (“Incremental Investment by System Size and Demand”; “Incremental Fill by System Size and Demand”), which compare relative investment and fill factors of “OC” facilities with different capacities that are used to serve the same amount of demand. Consider a route with enough demand to fill the capacity of two OC3 facilities. By definition, the fill of the two OC3 facilities would be 100%. Alternatively, the carrier could elect to serve the route with the next largest facility available on the market, an OC12 facility. The same demand that would entirely fill the two OC3 facilities would fill half a single OC12 facility. The investment required for two OC3 facilities is about \$144,000, compared to about \$91,000 for a single OC3 facility. Thus, it would be more efficient to deploy a single OC12 facility in lieu of two OC3 facilities, despite the lower level of fill with the OC12. By analogy, the CLECs’ proposals use both the lower investment associated with the single OC12 facility, and the higher fill factor associated with the two OC3 facilities. The result is to lower, dramatically and artificially, investment per trunk and high-

Growth. Sufficient spare capacity also permits carriers to meet the constantly shifting demand for additional lines and incremental demand growth without having to install new cables for every order. This is particularly true in Qwest's in-region service area, because the overwhelming majority of loop plant (between 70% and 80%) is buried and requires Qwest to dig new trenches whenever it must install additional cable. Thus, Qwest's practice is to deploy sufficient distribution capacity at the time of initial installation so that it can fill orders for additional lines without having to dig new trenches each time.

Vacant premises. At any given point in time, a number of customer premises connected to the network are unoccupied (*e.g.*, vacant houses awaiting occupancy by new owners). To avoid the costs associated with manual cross-connect activities that would otherwise be required to disconnect the line when the premises are first vacated, and to reconnect the line when new customers move in, carriers keep the line connected to the switch -- an efficient practice assumed by the CLECs' proposed NRCs. However, leaving idle lines connected decreases the fill on the switch by dedicating inactive ports to vacant premises -- a fact ignored by the CLECs' proposed switching fill factors.¹⁰⁶

Losses of Customers to Other Facilities-Based Carriers. Consistent with the ILEC's obligations as the "carrier of last resort" for its service territory, the Commission's UNE pricing rules assume that the replacement network is capable of "serv[ing] all customer locations within a particular area." *Notice* ¶ 49. However, the fact that a network has the *capacity*

capacity loop. *See* AZ Cost Docket, Tr.Vol. VII, July 30, 2001 (AT&T Witness Thomas Weiss) at 1575-79.

¹⁰⁶ Compare MN Cost Docket Order at 16 (finding erroneous the CLECs' proposed exclusion of investment for idle lines to vacant premises) *with id.* at 34 (adopting CLECs' proposed switch fill (94%) notwithstanding failure to account for switch ports dedicated to idle lines).

required to serve all demand does not mean that it is a monopoly. To the contrary, ILECs already face substantial levels of facilities-based competition for local telecommunications service, including competition from cable companies and wireless carriers. Debates about the current amount of facilities-based competition are unnecessary, however, for TELRIC assumes the existence of “widespread facilities based competition” right now. *Notice* ¶ 10. In determining costs, state commissions must account for competitive losses to other carriers that would be expected under that assumption.

In this regard, the discussion in the *Wireline Competition Bureau VA Arbitration Order*, of the impact of competition on fill factors is another illustration of the problems with how TELRIC is being applied. There, the Bureau notes that “there may be some merit” to the argument that “competition will lead to greater fluctuations in demand” that should be reflected in determination of fill factors.¹⁰⁷ However, it then dismisses the argument, speculating (without any evidence or empirical analysis) that “it also may be the case that companies in a competitive market would develop more efficient mechanisms to respond to these fluctuations (*e.g.*, more creative marketing and pricing strategies and more flexible architectures).” *Id.*

The Bureau’s discussion is flawed in two respects. First, the Bureau’s characterization of the issue as “demand fluctuation” suggests that it has either ignored the network ubiquity assumption, or has not accepted the holding in the *Triennial Review Order* that widespread facilities-based competition is to be assumed in determining all inputs.¹⁰⁸ The phrase “demand fluctuation” suggests modest and temporal peaks and valleys within a relatively narrow overall range, not the more substantial losses of share that a ubiquitous carrier would experience in the

¹⁰⁷ *Wireline Competition Bureau VA Arbitration Order*, 18 FCC Rcd. at 17820 ¶ 249.

¹⁰⁸ *See Triennial Review Order* ¶ 680; part I.D., *supra* (discussing the requirement that assumptions underlying inputs and components of TELRIC prices be consistent).

transition to a market with widespread facilities-based competition.¹⁰⁹ Second, if the Commission were to allow UNE rates to be based on the kind of vague, unsupported speculation that the Bureau properly rejected in connection with inputs other than fill factors, then the transformation of the UNE cost inquiry into an “unprincipled” exercise about the size of profit margins available to resellers under proposed UNE rates would accelerate rather than end.¹¹⁰

Against this background, the Commission should require that fill factors be determined by type of equipment assumed in the model and the demand for the element by customer location.¹¹¹ If the impact of competition on a ubiquitous network operating in a market served throughout by other facilities-based carriers is fully accounted for in determining the cost of capital,¹¹² the Commission should also establish a rebuttable presumption in favor of using the ILEC’s actual demand and modeled fill factors by type of equipment. At a minimum, the Commission should require that in determining TELRIC prices, state commissions consider and take into account each of the matters discussed above.

¹⁰⁹ As the capacity of non-dominant facilities-based interexchange carriers increased, the former monopolist AT&T saw its share of toll revenues decline from about 90% in 1984 to about 38% in 2001. *See* Statistics of the Long Distance Telecommunications Industry (Industry Analysis Division, Wireline Competition Bureau), released May 2003, at 3. It would not be accurate to characterize this decline as “fluctuation.” Moreover, the fact that the decline occurred over a period of a decade or more does not make the analogy inapt, for TELRIC is intended to “replicate” instantaneously (*see, e.g., Triennial Review Order* ¶ 680) the results of the competitive process.

¹¹⁰ *See Gifford* at 473; *see also id.* at 475.

¹¹¹ For instance, if an ILEC is currently serving a particular location with six DS1 facilities, but the model assumes the use of a single DS3 facility instead, the fill factor would be based on the demand served by the six DS1 facilities divided by the capacity of the DS3 facility.

¹¹² Alternatively, as discussed in the next section, the anticipated losses of a ubiquitous carrier operating in the fully competitive market assumed by TELRIC could be accounted for in determinations of the cost of capital. To the extent that this in fact occurs, then the impact of competition on fill factors may be discounted.

B. Cost of Capital

In the *Triennial Review Order* (§ 680), the Commission “clarif[ied] that a TELRIC-based cost of capital should reflect the risks of a competitive market,” including “the risk of losing customers to other facilities-based carriers.” The *Notice* (§ 86) seeks comment on the relationship between this risk and network assumptions, how the risk should be measured, and whether it may be reduced by long-term contracts.

The existence of a close relationship between the risk to an ILEC operating under the current TELRIC rules, and the network assumptions those rules require, is indisputable. Perhaps the most fundamental premise of TELRIC is that the “value” of the ILEC’s network is constrained by the most efficient technology that is currently deployed by a firm of similar size and scope. *See, e.g., Triennial Review Order* § 670. Under this premise, “[i]nvestments made today, totally embodying the most modern technology available currently, would instantaneously be outdated tomorrow and, in consequence fail over their lifetimes to earn a return sufficient to justify the investments in the first place.”¹¹³ As a matter of economics, that extraordinary risk must be accounted for in determining the return necessary to induce investment in the TELRIC replacement network.¹¹⁴ Indeed, risks (and thus the appropriate cost of capital) increase if and to

¹¹³ A. Kahn, T. Tardiff, D. Weisman, “*The Telecommunications Act at three years: an economic evaluation of its implementation by the Federal Communications Commission*,” 11 Information Economics and Policy 319, 326 (1999)(“Kahn/Tardiff/Weisman”).

¹¹⁴ *Id.* at 322, 326, 329. By contrast, “traditional regulatorily determined” costs of capital are “grossly insufficient” for that purpose. *Id.* at 328-29. *See also* T. Tardiff, Pricing Unbundled Network Elements and the FCC’s TELRIC Rule: Economic and Modeling Issues, 1 Review of Network Economics 132, 140 (Sept. 2002). There is no basis to assume that the risk of net competitive losses to other facilities-based carriers will be materially reduced by the use of long-term contracts. Most fundamentally, questions remain under the “pick and choose” rules about the ability of an ILEC to bind CLECs to long-term contracts. *See* 47 C.F.R. § 51.809; *see also* 47 U.S.C. § 252(i). In addition, other carriers will be free to offer long term contracts to their existing and prospective customers.

the extent that the Commission's pricing rules permit determination of the "costs" incurred to provide UNEs to be based upon: (1) the outcome of debates regarding the theoretical feasibility of hypothetical networks, technologies and practices, and (2) the assumed immediate and ubiquitous deployment of the latest technologies, etc. Increased risks requiring a higher cost of capital are also a natural consequence of: (1) cost definitions and rate structures that effectively shift to ILECs' costs caused by CLECs, and (2) operating a ubiquitous network in a market occupied by other facilities-based carriers with more than enough capacity to serve all of the incumbent's demand.¹¹⁵ Stated another way, hypothetical TELRIC is not market-based, and therefore would demand a return far in excess of anything that would be found in the market.

The most appropriate "proxy companies or industries for use" (*Notice* ¶ 88) in determining the cost of capital to be reflected in TELRIC rates are telecommunications carriers which currently face substantial competition: CLECs and interexchange carriers. A consultant to NARUC has estimated the pre-tax cost of capital of a CLEC to be 21.99%.¹¹⁶ This and other estimates of a CLEC's cost of capital are likely to understate the cost of capital used in the calculation of UNE rates under TELRIC, because the prices charged by CLECs are not

¹¹⁵ Cost of capital determinations should reflect all risks associated with the current "regulatory environment" (A. Kahn, T. Tardiff, D. Weisman, *The Telecommunications Act at 3 Years: An Economic Evaluation of its Implementation by the FCC*, 11 Information Economics and Policy 319, 329 (1999)), many of which are described by Professor Weisman in the paper (¶ 34) accompanying Qwest's comments. See also Reply Brief for Petitioners United States and the Federal Communications Commission at 12, n.8, (filed July 23, 2001), *Verizon v. FCC*, *supra*. ("an appropriate cost of capital determination takes into account not only existing competitive risk, as the FCC explicitly recognized . . . but also risks associated with the regulatory regime to which a firm is subject").

¹¹⁶ *Gabel* at Tab "CCCFactor." CLECs have included in documents submitted to the Commission in other proceedings, subject to protective orders, estimates of their cost of capital, but have refused to consent to their inclusion of these estimates in a nonpublic version of Qwest's comments. Other than to preclude consideration of these estimates in this docket, there is no reason for the CLECs to withhold their consent to including them in a non-public version of Qwest's comments.

constrained by the ubiquitous and instantaneous deployment of the most efficient technology, etc. In addition, CLECs have not built networks capable of serving all of the incumbents' demand and are not subject to "carrier of last resort" obligations, and can therefore size their networks with reference to the demand that they actual expect to serve.¹¹⁷

In addition to requiring that the cost of capital of CLECs and interexchange carriers be used to determine the cost of capital reflected in UNE rates, the Commission should itself prescribe the cost of capital for this purpose. The key assumption underlying cost of capital determinations -- the existence of a competitive market -- applies in all states. In addition, capital markets are national or global. Accordingly, there is no legitimate reason for the use of different costs of capital in different states. By prescribing the cost of capital, the Commission will thus further its goals (*Notice* ¶ 9) of minimizing the burden on state commissions of UNE rate proceedings, and reducing the number and magnitude of non-cost-based differences in rates adopted by state commissions for the same UNE or activity. The prescribed cost of capital should fall somewhere within the range of the estimated costs of capital submitted in the CLECs' analyses of "impairment" without access to UNEs, which the Commission should require the CLECs to provide for use in this docket, subject to a protective order if deemed appropriate.

¹¹⁷ The observation in the Notice (¶ 59) that costs of capital "might be lower under a regime that looked at an ILEC's existing network rather than the most efficient network available today" is not relevant to the rebuttable presumption proposed by Qwest. As explained, *supra* at 19-22, the subject of the proposed presumption is *not* the ILEC's "existing network," but a replacement network that uses *throughout* the most efficient technologies and practices the ILEC currently deploys. The Bureau has opined and AT&T has conceded that this approach is consistent with forward-looking principles. *Id.* For the same reason, there is no inconsistency between basing UNE rates on the CLECs' cost of capital, and the costs of a *replacement* network that utilizes the most efficient technologies deployed by the ILEC. The approach used by Qwest assumes the costs that would be incurred in a competitive market, but simply requires real as opposed to hypothetical evidence. The ILEC's actual cost of capital does not assume the widespread deployment of facilities by other carriers.

C. Operating Expense

In recent cost dockets in Qwest's region, CLECs propose operating expenses that are only a small fraction of those that Qwest actually incurs (after ten years of operating with the incentives created by price cap regulation of interstate and intrastate services). For example, HAI version 5.3, which the CLECs have proposed for use in cost dockets in Oregon and Washington, estimates that a hypothetical efficient carrier could immediately reduce operating expenses in those jurisdictions by 83% and 79%, respectively. The results adopted by state commissions for Minnesota and Arizona based on HAI version 5.2 allow recovery of only 33% and 29%, respectively, of the expenses incurred by Qwest today to run and operate the network.

These proposals and results are devastating to the prospects for investment by CLECs and ILECs alike. As with any other component of costs, setting expenses too low will distort the correct economic signals that CLECs are supposed to receive from TELRIC prices. In addition, failing to provide adequate recovery of expenses jeopardizes the ability of ILECs to provide the high quality, innovative and reliable services that customers demand. No objective party would seriously contend that an ILEC could eliminate 70-85% of its workforce without jeopardizing customer service levels.

The enormous disparities between the ILEC's actual operating expenses and those proposed by the CLECs are largely attributable to the use of "factors." A methodology that uses factors does not attempt to forecast, either from the "top down" or the "bottom up," the level of expenses that an efficient firm would incur. Rather, it simply varies the recoverable amount of expenses in direct proportion to the forecast of forward-looking investment in facilities. The use of a factors-based methodology provides the CLECs with a convenient excuse for their failure to identify a single example of an inefficient practice or decision by Qwest that accounts for even a portion of the disparity between Qwest's actual expenses, and the "hypothetical" expenses they

propose. As explained below, it is unreasonable to use factors to estimate expenses, except with respect to the calculation of maintenance expenses, where a change in the composition of the network precludes a different approach.

In particular, there is no basis for the assumption that there is a significant correlation, much less the precise dollar-for-dollar correlation assumed by the use of factors, between changes in the amount of per-line investment, and changes in the amount of per-line expenses. Stated another way, the key premise underlying a factors-based methodology is that changes in expenses per line mirror changes in investment per line.¹¹⁸ That premise, however, is supported by neither intuition, logic nor empirical analysis.

Consider the investment in a fleet of trucks used by technicians to maintain the network. Although prices payable by carriers to automotive manufacturers or dealers may decline over time, or an efficient carrier might choose to purchase less expensive but functionally equivalent models, no one would suggest that changes in prices or purchasing strategies would have a corresponding impact on the price of gasoline used to operate the fleet, or the expenses incurred to maintain and repair it. Yet that is precisely what is assumed by the factors-based methodology proposed by CLECs and adopted by state commissions.

The same point may be illustrated by examining the impact of structure sharing assumptions on maintenance expenses, as calculated for the state of Washington using HAI version 5.3 and its default assumptions for other inputs. When run with the assumption that sharing is only 10% (*i.e.*, the ILEC bears 90% of placement costs), the model estimates

¹¹⁸ It is important that the existence of any correlation between investment and expenses be determined on a “per line” rather than aggregate basis. Otherwise, the inquiry may be distorted by changes in the volume of demand. As explained *infra*, it may be reasonable to assume some correlation between changes in investment and expenses that are attributable to changes in demand. The approach used in UNE cost dockets, however, assumes such a correlation even when demand is held constant and the changes are due to other reasons.

maintenance expenses equal to 48% of those that Qwest actually incurs. If the sharing assumption is changed to 90% (*i.e.*, the ILEC bears only 10% of placement costs), estimated maintenance expenses are only 39% of actual expenses. Yet no one has suggested that the amount of expenses incurred to maintain a loop has anything to do with the number of carriers that share the cost of installing it.

Indeed, to the best of Qwest's knowledge, no party has ever attempted to demonstrate to a state commission through any empirical evidence that there exists any correlation between per-line changes in investment and expenses. While it is not proper to require an ILEC to disprove the reasonableness of an approach proposed by another party, data collected by Qwest demonstrate that no such correlation exists.¹¹⁹ In particular, Qwest undertook a study using data from ARMIS reports on investment and expenses of nine local exchange carriers, including all four Regional Bell Operating Companies, for the years 1996-2002, inclusive.¹²⁰ Qwest then calculated correlation coefficients across the nine companies to determine the relationship, if any, between differences in per-line investment and differences in per-line expenses. The results, set forth in the chart attached hereto, show no significant positive correlation between differences in per-line investment and per-line expenses for four years, and a *negative* (albeit insignificant) correlation for three years (*i.e.*, higher investment but lower expenses, or vice versa).¹²¹

¹¹⁹ It would violate fundamental evidentiary principles to place on a party the burden of disproving the unreasonableness or invalidity of a methodology, model or assumption proposed by another party. *See infra* at 64-65.

¹²⁰ The other carriers were Alltel, Cincinnati Bell, Citizens Communications, Sprint (local telecommunications division) and Commonwealth Telephone.

¹²¹ "Comparison of Investment Per Line to Expense Per Line Correlation Analysis." The data also show a very close positive correlation between changes in expenses and the number of

The current abuses perpetrated in UNE arbitrations and cost dockets with regard to operating expenses are not limited to the use of “factors.” When the application of factors to the CLECs’ “hypothetical” investment figures does not produce estimates of expenses low enough to satisfy their advocates, the CLECs propose “secondary” adjustments, often with little explanation and no support, to further reduce the estimates.

Compelling examples of unsupported secondary adjustments that eliminated over \$50 million in operating expenses in Minnesota alone are those proposed by AT&T/MCI and adopted by the Minnesota commission in its 2002 UNE cost docket. When the application of factors to the paltry levels of hypothetical investment imagined by their model did not produce expense figures low enough to suit them, AT&T/MCI proposed secondary adjustments to further reduce by approximately 50% the costs of purchasing and maintaining general support assets (*e.g.*, vehicles, work equipment, buildings, general purpose computers), with virtually no explanation and absolutely no support.

Specifically, in their direct case, AT&T/MCI made only the vaguest reference to the proposed adjustments. Later in the proceeding, an AT&T/MCI witness opined in surrebuttal testimony that: (1) “many of the expenses Qwest incurs for [general support assets] are related directly to [Qwest’s] retail operations,” (2) “[i]t would be inappropriate to force a CLEC’s retail customers to pay for Qwest’s retail expenses,” and (3) “HAI attempts to allocate these expenses between Qwest’s retail, wholesale and corporate operations.”¹²² AT&T/MCI offered nothing

lines. This correlation, however, provides no support for the key premise underlying the factors-based methodology: that reduced investment per line correlates to reduced to expenses per line.

¹²² MN Cost Docket, AT&T Witness Douglas Denny Surrebuttal, dated May 9, 2002 at 32-33. The AT&T/MCI witness made no effort to explain *how* “HAI attempts to allocate expenses between retail, wholesale and corporate operations,” or why the amount of the allocation is reasonable. See *JB Hunt Transport, Inc. v. General Motors Corp.*, 243 F.3d at 444 (upholding exclusion of expert opinion “unconnected to existing data” other than “by the *ipse dixit* of the

beyond these unsubstantiated assertions. In particular, they provided no testimony explaining: (1) why or how, prior to the adjustment, the figures produced by their own methodology, which was designed to develop the costs of a *wholesale* network, included *retail* costs,¹²³ (2) the methodology used to determine the amount of retail costs that were purportedly included prior to the adjustment,¹²⁴ (3) why that methodology accurately estimated the amount of retail costs that were improperly included by prior to the adjustment, or (4) how to reconcile (a) the resulting proposal that computer costs be set at less than 25% of Qwest's current investment and operating costs relative to general support computers, with (b) their separate proposal for non-recurring charges that assumed that Qwest's network was almost entirely automated. The Minnesota commission nevertheless adopted the proposed adjustment, reasoning -- in violation of basic evidentiary principles (*see infra* at 64-65) -- that Qwest had failed to prove the adjustments to be "incorrect."¹²⁵

expert"); *Bonner v. ISP, Technologies, Inc.*, 259 F.3d at 929 ("it is the expert witnesses' methodology, rather than their conclusions, that is their primary concern"); *Minasin v. Standard Chartered Bank*, 109 F.3d 1212, 1216 (7th Cir. 1997) (expert affidavit "that is full of vigorous assertion and carefully tailored to support plaintiff's position but devoid of analysis" "exemplifies everything that is bad about expert witnesses in litigation").

¹²³ The witness's observation (AT&T Witness Douglas Denny Surrebuttal, *supra* at 32-33) that "many of the expenses Qwest incurs are related directly to Qwest's retail operations" is quite irrelevant, for the HAI model does not attempt to compute *Qwest's* costs, but rather the costs that would be incurred by an efficient provider of network elements to wholesale customers.

¹²⁴ The appropriate share of GSA costs estimated by the CLECs' methodology would have been allocated to Qwest *prior to the secondary adjustment* under the rule that UNE prices are determined by spreading costs across all units of demand, including the portion thereof served by the ILEC's retail operations (*see Local Competition Order*, 11 FCC Rcd at 15845¶ 677, 15847-48 ¶ 682) -- a fact that AT&T/MCI never disputed. Thus, the effect of the secondary adjustment to general support costs was to require Qwest and its retail customers to bear more than twice the per-line share of such costs allocated to CLECs and their customers.

¹²⁵ *MN Cost Docket Order* at ¶¶ 66-67.

A third violation of TELRIC by the CLECs in estimating expenses is their exclusion of those associated with product management and certain other wholesale functions. ILECs, like all other producers of goods and services, incur expenses in addition to “the cost of goods sold” in dealing with their wholesale customers. Qwest has a dedicated organization, consisting of over 1,400 employees, to serve the wholesale market. The responsibilities of this organization include but are not limited to, negotiating new and amended interconnection agreements, handling CLEC pricing inquiries, arranging for order escalations and expedited assistance sought by CLECs, responding to requests for products and services to meet CLECs’ particularized needs, developing products and services in response to or anticipation of market and regulatory developments, and soliciting, compiling and analyzing data and feedback on the performance of products provided to CLECs.¹²⁶ This organization is entirely separate from the organizations within Qwest that support its retail products and customers.¹²⁷

Although the cost of Qwest’s dedicated wholesale organization are clearly incurred in the provision of UNEs to CLECs, and would be recovered in unregulated, competitive markets,¹²⁸ the CLEC proposals adopted by state commissions do not provide for any recovery of those costs. The effect of the CLEC proposals is thus to “shift costs to the incumbent LEC,” which “hinders the ILEC’s ability to compete.”¹²⁹ It is no less anticompetitive to require an ILEC to bear expenses incurred to support the CLECs’ than it is to require CLECs to bear expenses

¹²⁶ See, e.g., Direct Testimony of E. Craig Morris, Docket No. UT-23003 (WUTC), filed October 1, 2003.

¹²⁷ *Id.* at 3-4.

¹²⁸ J. Sidak and D. Spulber, *The Tragedy of the Telecommons: Government Pricing of Unbundled Network Elements Under the Telecommunications Act of 1996*, 97 Colum. L. Rev. 11081, 11117 (1997).

¹²⁹ *Id.*

incurred by the ILEC's retail operations. Denying recovery of these costs in UNE rates also provides CLECs "an additional strategic incentive to demand unique, customized wholesale and access services from the ILEC."¹³⁰ Finally, allowing CLECs to bear less than the full economic costs of the services they purchase distorts the investment signals that TELRIC prices are supposed to send.

To address the problems discussed above, the Commission should prohibit the determination of expenses based on "factors," and require that expenses recovered in UNE rates be based on the ILEC's current actual expenses.¹³¹ These would be subject to adjustment based on actual marketplace evidence of known and measurable efficiencies achieved by other carriers, provided that any additional investment required to achieve these efficiencies is also included in the determination of and recovered by UNE rates.¹³² This approach is far more likely than the use of factors to result in the kind of realistic projections of expenses that would be used in making investment decisions, and would provide all parties with the appropriate incentives to operate efficiently.

In addition, the Commission should prohibit "secondary adjustments" without detailed explanations and evidentiary support. The Commission should also make clear that because network-related expenses per line are allocated across all units of demand, including the portion

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Id.

¹³¹ Costs and expenses associated with the ILEC's retail functions would continue to be excluded from the current actual expenses an ILEC is permitted to recover.

¹³² The Bureau has agreed "in theory . . . that forward looking expenses can be calculated by applying a productivity factor to current expenses." *Wireline Competition Bureau VA Arbitration Order*, 18 FCC Rcd at 17779-80 ¶ 138. Under Qwest's proposal, in lieu of a productivity factor, forward-looking adjustments would be based on known and measurable efficiencies that have actually been achieved by other carriers. Such an approach is equally, if not more, consistent with forward-looking principles.

thereof served by the ILEC's retail operation, no secondary adjustments to allocate an additional share of expenses to the ILEC are warranted.

Finally, the Commission should make clear that the costs incurred to provide UNEs, and thus recoverable in UNE rates, include the costs incurred to develop products for and manage relationships with wholesale customers, as described above.

D. Non-recurring Charges

Non-recurring costs are those incurred by an ILEC to process and provision UNE orders placed by CLECs. Such costs are primarily a function of the labor needed to perform the tasks involved. *Notice* ¶ 120. The "non-recurring" label reflects the manner in which they are incurred, *i.e.*, all at once in connection with a single order. When recovered in the same manner; the associated charges are referred to as non-recurring charges (or NRCs).

Perhaps due to the particular lack of Commission guidance regarding NRCs, no area of UNE pricing has been more susceptible to CLEC manipulation. Within Qwest's region, state commissions have ordered basic installation charges that range between \$4.00 and \$55.00 for the exact same activity. Charges at or toward the low end of this range are based on CLEC proposals that violate TELRIC in numerous fundamental respects. Among other things, the CLEC proposals: (1) assume deployment by the ILEC of fully automated systems that exist only in the imaginations of the CLECs' advocate-directed consultants, (2) do not provide for recovery of the investment that would be incurred to obtain and install those systems, (3) are based upon estimates of work times and flow-through unsupported by any documentation or other support, and (4) assume away orders faxed by CLECs that require manual processing, based on the view

that in estimating costs incurred by ILECs, the Commission's rules require or allow state commissions to assume that the CLECs placing orders do so via the most efficient technology.¹³³

In the *Notice* (§ 117), the Commission properly expresses “practical concern” about using assumptions “that depart significantly from an ILEC's existing network” to determine the costs they incur to initiate service and provision orders for CLECs.¹³⁴ That concern is exacerbated by the CLECs’ excessively “hypothetical” approach to TELRIC. The Commission also emphasizes (*id.*) the importance of using consistent sets of network assumptions for recurring and non-recurring charges. The Commission’s concern about assumptions that depart from the ILEC’s existing network, and its desire for consistency, can both be addressed by adopting Qwest’s proposal to base the costs of non-recurring activities on those the ILEC actually incurs. Any concerns about the ILEC’s “incentives to be efficient when CLECs are the primary users of a particular activity” (*id.* § 119) are addressed by the possibility of adjustments based on actual marketplace evidence of known and measurable efficiencies achieved by other carriers.¹³⁵

¹³³ CLECs never identify the costs of the new technologies or systems that purportedly would allow orders to flow through automatically and eliminate virtually all manual intervention, much less include them in their cost estimates. In Minnesota, for example, instead of including in their estimates the costs of these new and additional technologies and systems, the CLECs’ estimates *reduced* by 75% the costs incurred by Qwest using its existing systems. *See* 50-51, *supra*.

¹³⁴ The Commission’s concern is supported by sound principles of economics. As Professor Weisman explains (§ 52) “economic efficiency and competitive neutrality require that new entrants pay for the actual costs that they cause to be incurred in leasing UNEs,” and it would be “a clear violation of this principle for regulators to shift the burden of financing market entry from rivals to incumbent providers and their customers.”

¹³⁵ Of course, an adjustment would not be appropriate unless any investment or other costs incurred to achieve the efficiencies is recovered in UNE rates. Otherwise, the ILEC would be subsidizing CLECs, and the investment signals conveyed to CLECs by prices would be distorted.

The Commission should also require that non-recurring costs be recovered through non-recurring charges.¹³⁶ The Commission does not dispute that such a rule is consistent with its conclusion in the *Local Competition Order* that “rates for unbundled network elements should recover costs in the manner in which they are incurred” (*Notice* ¶ 115), and with economic principles (see Weisman ¶¶ 50-51). It nevertheless expresses concerns about the imposition of NRCs for activities that benefit CLECs in addition to the one placing the order, and about “barriers to entry.” The premises underlying these concerns are vastly overstated, and do not warrant the departure from economic principles that would result by requiring recovery of non-recurring costs in recurring charges. Indeed, such a departure would represent an extension of policies that appear to reflect a regulatory preference for resale as opposed to facilities-based entry -- policies that the Commission elsewhere in the *Notice* disclaims.

For example, the implication that the installation of a cross-connect at the feeder/distribution interface (“FDI”) benefits CLECs or other customers in addition to the CLEC placing the order (*Notice* ¶ 122) is incorrect. Specifically, it is not true, as claimed by CLECs, that once installed, a cross-connect can always be used for succeeding customers. Even for non-recurring activities that do benefit initial and subsequent carriers, moreover, requiring or permitting the associated costs in recurring charges is not an appropriate solution. The result of such an approach would be to impose costs on all CLECs (or at least all CLECs subject to

¹³⁶ In no event should states be “accorded discretion” (*Notice* ¶¶ 115, 129) with regard to whether or how non-recurring (or other) costs should be recovered. It is well settled that “federal statutes are generally intended to have uniform nationwide application.” *Turner v. Perales*, 869 F.2d 140, 141 (2d Cir. 1989). Thus, results should vary by state only as warranted by differences in facts. Allowing states to adopt different rules based on their individual policy preferences will, at best, encourage the kind of uncertainty and inconsistency that has hindered investment in the telecommunications industry and, at worst, could encourage the classic “race to the bottom” as state commissions compete for the more immediate yet “synthetic” and limited form of competition (*USTA v. FCC*, 290 F.3d at 425) offered by the UNE Platform. See *Gifford* at 475.

payment of the recurring charges), including CLECs that will not benefit from the activity. This departure from principles of cost causation is another form of cost shifting that promotes inefficiency. *See Weisman* at ¶¶ 51-52. In all events, there are means other than recurring charges to ensure an equitable distribution of non-recurring costs among carriers that benefit from a non-recurring activity, as suggested in the *Local Competition Order*. *See Notice* ¶ 115.

The Commission's concerns (*id.* ¶ 114) about barriers to entry arising from the combination of NRCs and customer churn are likewise overstated, and in all events do not justify departing from cost causation principles. New entrants in all industries incur risks that set-up costs will not be recovered,¹³⁷ and customer churn is a natural characteristic of many competitive markets. The costs of customer churn, moreover, are not limited to resale CLECs, but are also an issue for other CLECs, as well as ILECs. Facilities-based CLECs also have start-up costs, including set-up costs incurred once it has acquired a customer. Insulating resale CLECs from a risk that applies no less to other CLECs alters the competitive neutrality between entry methods that the Commission's rules are intended to foster, and is a further reason for new entrants to prefer resale over facilities-based entry methods. *See Weisman* ¶ 54.

From a wholesale perspective, churn increases the actual costs incurred by the ILEC in processing and provisioning CLEC orders. The impact of industry churn on the ILEC's wholesale operations is exacerbated to the extent that the Commission does not permit the ILEC to recover its actual costs by, for example, adopting a different definition of the relevant costs. With respect to the ILEC's retail operations, legacy regulation frequently prohibits the recovery of set-up costs from retail customers through NRCs. Thus, the ILEC's retail operation faces the same risk of non-recovery of non-recurring costs as do CLECs. Insulating CLECs exclusively

¹³⁷ *USTA v. FCC*, 290 F.3d at 427.

from a risk to which the ILEC's retail operations are also subject would provide them with a competitive advantage.¹³⁸ See *Weisman* ¶ 54.

The above discussion underscores that the source of the “risk” of non-recovery of nonrecurring costs and charges is not a rate structure that complies with accepted principles of cost causation, but participation in a competitive market. The market-oriented way to reduce the risks of competitive losses is to offer rates, terms, conditions, and a customer care experience that are sufficiently attractive to induce customers to agree to commit to a term of service long enough for the carrier to recover all of its costs, including NRCs.¹³⁹ Wireless carriers, for example, have successfully utilized attractive offers conditioned on term commitments to ensure recovery of their substantial set-up costs.

Resale CLECs, including CLECs that rely on UNE-P, may reduce churn through price reductions and superior customer care. To the extent that a CLEC relies on facilities and equipment other than those of the ILEC, the CLEC would also have the option to reduce churn by differentiating the quality and functionality of the service it offers consumers. Regulations intended to reduce risks associated with the competitive process necessarily reduces the need and incentives of carriers to develop market-based responses, including investing in facilities that will allow them to differentiate themselves from competitors. Such regulations would stand on its head the “more market driven system” (*Pacific Bell v. Pac-West Telecomm Inc.*, 325 F.3d 1114, 1128 (9th Cir. 2003)) that Congress intended to create in the 1996 Act, and would discourage rather than promote facilities-based competition.

¹³⁸ The Commission's apparent lack of jurisdiction over *retail* rates and rate structures neither requires nor justifies a *wholesale* regulation that would insulate resale CLECs alone from risks to which facilities-based CLECs and ILECs are also subject.

¹³⁹ Of course, another way for competitors to reduce churn would be to differentiate their offers in terms of quality, features and functions.

E. Deaveraging

The *Notice* (§§ 136-37) seeks comment on proposals to modify the deaveraging requirements adopted in the *Local Competition Order*. In this regard, the Commission should be guided by the pro-competitive intent of the Act, and take care to ensure that its actions do “not preordain the competitive outcome.” In addition, the Commission should, consistent with other aspects of its UNE pricing rules, seek to foster policies aimed at achieving the same results that would be expected in competitive markets.

Yet the concept of fostering the results that would obtain in competitive markets seem to have been ignored in the open ended discussion of deaveraging in the *Local Competition Order*. That has led some state commissions to make the same error, and propose deaveraging schemes that would never be seen in competitive markets, and would impose substantial costs on carriers and their customers, with no offsetting benefits. More specifically, several state commissions appear to be seriously considering pricing schemes that vary from block to block across major metropolitan areas; for example. No evidence has been submitted in these dockets that retail prices in any markets come even close to the geographic variation under these proposed deaveraging schemes. No CLEC participating in these dockets has requested or supported these schemes, and some have affirmatively opposed them. Ironically, the deaveraging schemes could prevent ILECs from complying with the requests of their CLEC customers.

In Washington, for example, the state commission is suggesting a deaveraging scheme that would first segregate the state into wire center zones and then disaggregate rural zones into distance-based zones.¹⁴⁰ This scheme is being proposed despite substantial implementation costs

¹⁴⁰ In the Matter of Review of Unbundled Loop and Switching Rates and Review of the Deaveraged Zone Rate Structure, Docket No. UT-023003 (WUTC), Direct Testimony of Thomas L. Spinks, dated June 26, 2003, Section entitled “Cost Model Results and Deaveraging Proposals.”

and the complete absence of support by an company active in the docket. Indeed, the CLEC proposals do not require deaveraging below the wire center level. The CLEC witness on the HAI model has testified that he opposes the excessive deaveraging, stating that he did not support the deaveraging scheme under consideration by the state commission.¹⁴¹

An even more extreme approach to deaveraging was initially ordered in Colorado in its recent cost docket. In its initial Ruling on Applications for Rehearing, Reargument or Reconsideration,¹⁴² the Colorado state commission adopted a deaveraging scheme that resulted in 166 separate loop rates across Colorado. This was 162 more loop rates than proposed by any party to the proceeding, including the commission's staff. Had the Commission ultimately adopted this pricing scheme, it would have that required significant alterations to each of Qwest's service ordering, provisioning and billing systems, increasing rates for Qwest, CLECs, and their customers.¹⁴³ In a subsequent decision, the Colorado commission adopted Qwest's deaveraging proposal on an interim basis, subject to a "critical look at deaveraging in the next phase of this proceeding."¹⁴⁴ The deaveraging scheme to be considered in the next phase of the

¹⁴¹ In the Matter of Review of: Unbundled Loop and Switching Rates; the Deaveraged Zone Rate Structure; and Unbundled Network Elements, Transport, and Termination, Docket No. UT-023003 (WUTC), Direct Testimony of Dr. Mark T. Bryant, dated June 26, 2003, Section entitled "Deaveraging Loop Costs Properly."

¹⁴² *CO PUC Cost Docket Rehearing Order* at Attachment B.

¹⁴³ In the proceeding, Qwest indicated that its "initial analysis indicates that at a minimum, Qwest would have to invest 50,000 hours and \$3 million" to implement the systems changes necessary to comply with the state commission's deaveraging scheme. The required work was projected to require at least "nine months to complete." In the Matter of U S WEST Communications, Inc.'s Statement of Generally Available Terms and Conditions, Docket No. 99A-577T (CO PUC), Qwest Corporation's Application for Rehearing, Reargument and Reconsideration or, in the Alternative, Motion for Waiver, Affidavit of Lynn M. Notarianni, May 7, 2002, at 2.

¹⁴⁴ In the Matter of U S WEST Communications, Inc.'s Statement of Generally Available Terms and Conditions, Docket No. 99A-577T, Decision on Applications for Rehearing, Reargument, or Reconsideration, May 29, 2002, at 12-15.

cost docket: (1) includes deaveraging rates by wire center depending on distance from the central office (*i.e.*, significantly more than the 166 rates initially ordered by the state commission), (2) was not proposed or endorsed by any party in the proceeding, and (3) is inconsistent with any pricing scheme that ever existed in a competitive market.

The deaveraging schemes discussed above ignore the Commission's objective to adopt pricing rules that replicate deregulated and competitive markets, with no offsetting justification. Most companies offering consumer products charge a standard price throughout their defined markets. Cable companies, for example, which are not subject to retail rate regulation in most circumstances, charge one uniform price for a given service across large metropolitan areas, regardless of cost differences between various segments of the city. This is the common practice for companies in most competitive markets. Standard prices across markets reduce customer confusion, are easier and less costly to implement, and facilitate market-wide advertising campaigns and other promotions. By contrast, the Act's requirement that rates be "cost-based" does not justify ignoring these matters, as a certain amount of averaging is necessary in any wholesale pricing scheme. Indeed, consideration of these matters in deciding the amount of deaveraging that may be required is entirely consistent with the Act's deregulatory objectives.

Accordingly, the Commission should: (1) clarify that in determining the number and configuration of zones for which rates must be deaveraged, state commissions should consider marketing and operating limitations similar to those of firms in unregulated and competitive markets, and (2) set a limit on the number of cost based zones a state commission may adopt, thereby minimizing the costs of implementing two totally different deaveraging schemes.

III. THE COMMISSION SHOULD ADOPT ADDITIONAL BINDING EVIDENTIARY AND PROCEDURAL GUIDELINES, AND ENCOURAGE PARTIES TO SOLICIT FURTHER GUIDANCE ON NON-FACTUAL ISSUES THAT ARISE IN THE FUTURE THROUGH PETITIONS FOR DECLARATORY RULINGS AND PRIMARY JURISDICTION REFERRALS

Parts II and III of these comments urged the Commission to require that determinations of the costs incurred to provide UNEs be supported by actual market place evidence of real world networks and practices, and that models, inputs and assumptions used in those determinations be consistent, transparent, and verifiable. Part III discusses additional evidentiary and procedural guidelines that will increase the availability and objectivity (*Notice* ¶ 61) of information used to determine costs, resulting in rates that are both more consistent and likely to achieve the goals identified in the *Notice*.

A. The Commission Should Require Disclosure Of Data In The Possession Or Control Of Other Facilities-Based Carriers, And Prohibit The Use Of Models, Inputs And Assumptions That Rely On Data, Including Those Owned Or Controlled By Third Parties, That Are Not Disclosed In Cost Dockets Or Arbitrations

The *Notice* (e.g., ¶¶ 56, 61) seeks comment on the sources and types of data that should be considered in proceedings to determine costs. The emphasis in the *Notice* is on “objective sources” and “verifiability” of inputs and points to but one conclusion: unless the Commission deems conclusive the ILEC’s actual costs, state commissions should encourage and facilitate the efforts of parties to collect from carriers subject to their jurisdiction, including CLECs and interexchange carriers, documents and information in their possession, custody and control that are relevant to their costs (including the components thereof) of acquiring, constructing, expanding, replacing, modifying, maintaining and operating their networks. *See Notice* ¶ 56. There simply is no more objective and reliable way to determine the long-run costs of the most efficient technology than by identifying and “understanding the costs of today’s most efficient

producers.”¹⁴⁵ Stated another way, judgments regarding the ILEC’s costs and the components thereof cannot be made without comparisons to other empirical sources, such as the costs incurred by other facilities-based carriers, including other ILECs and CLECs. The alternative, reliance on speculative conclusions on the theoretical feasibility of hypothetical networks, is simply incapable of producing “objective” and “principled” results.¹⁴⁶

A firm and unambiguous statement by the Commission affirming the relevance of data of other facilities-based carriers will not, however, be sufficient to require its disclosure to state commissions and other parties. That is because in addition to contesting the relevance of these data, CLECs frequently seek to withhold them on the grounds that they are “proprietary” to the CLEC, or its consultant or other vendor.¹⁴⁷ Indeed, the CLECs’ efforts to hide data that contradicts the assumptions in or used with their cost models continue through this very day, as evidenced by the CLECs’ rejection of each and every request by Qwest to permit the submission of such data in a *non-public* version of these comments, including data they have already provided to the Commission in other dockets.

The Commission and the courts have recognized that the appropriate response to legitimate concerns about requests for and use of proprietary information is not to allow it to be

¹⁴⁵ *AT&T v. Illinois Bell*, slip op. at 2.

¹⁴⁶ *See Notice* ¶ 119; *Gifford* at 426.

¹⁴⁷ WorldCom Inc.’s Response To Qwest Motion To Compel Discovery Responses, (NM Cost Docket), Dec. 9, 2002, pp. 7-10; *see also* AT&T and WorldCom’s Opposition to Qwest’s Motion to Compel Discovery, Docket UN 1025 (OR PUC), April 17, 2003, pp. 1-8; AT&T/WorldCom Responses to Qwest Motion to Compel, Docket No. UT 023003 (WUTC), Aug. 22, 2003, pp. 2-5; AZ Cost Docket, Tr. Vol VI, July 27, 2001 (AT&T Witness Douglas Denny) pp. 1374-77; MN Cost Docket, Deposition of AT&T Witness Dean Fassett, April 5, 2002, pp. 161-65, 226; Deposition of AT&T Expert Richard Chandler, April 26, 2002, pp. 71-72.

withheld, but to require its production subject to appropriate restrictions on use and access.¹⁴⁸

Accordingly, the Commission should modify its rules to provide that a party subject to the jurisdiction of the state commission may not: (1) withhold from parties to a proceeding to determine UNE rates documents or information it holds or controls relevant to the costs of building or operating a network, or (2) rely upon or seek to justify costs, models, inputs or assumptions it has proposed in a proceeding to determine UNE rates that were provided by, incorporate or are based upon documents or information that have not been disclosed to other parties to the proceeding. The latter requirement will ensure the verifiability of information provided by third-party vendors and consultants, and encourage parties to eliminate impediments to disclosure at the outset of their relationships with such third parties. The Commission's rules should also provide that state commissions may require that disclosure of proprietary documents and other information be subject to a protective order placing appropriate restrictions on use and access.

B. The Commission Should Clarify The Relevance and Application of the "Burden of Proof" in UNE Rate Proceedings

In its *Triennial Review Order* (§ 92), the Commission rejected "a 'burden of proof' approach that places the onus on either ILECs or competitors to prove or disprove the need for unbundling." Rather, the Commission stated that in the application of the "impairment" standard, the better approach would be to "examine the record evidence in light of the Act's goals to make the best determination." *Id.* In this proceeding, the Commission should adopt an "evidentiary guideline" requiring a similar approach to the determination of UNE prices.

¹⁴⁸ The Commission has entered protective orders to address concerns about information claimed to be "proprietary" in nearly every major proceeding it has conducted under the Act, including all Section 271 proceedings and the Triennial Review.

Alternatively, the Commission should allocate the burden of proof to the proponents of the model, input or underlying fact.

An evidentiary guideline regarding the burden of proof in UNE rate proceedings is necessary to prevent the adoption of a proposed model or input, or asserted fact, with insufficient evidentiary support, based on a “finding” that other parties have not proven it to be unreasonable. In Minnesota, for example, the state commission interpreted the Commission’s rules to require or permit the adoption of the CLECs’ proposals for the costs of high-capacity loops and general support assets, notwithstanding the conceded absence of explanation or supporting documentation, on the ground that Qwest purportedly had failed to prove the proposals to be “inadequate” or “incorrect.”¹⁴⁹ The allocation of the burden of proof to a party other than the proponent of the proposal or fact at issue is contrary to both the Administrative Procedure Act¹⁵⁰ and common law.¹⁵¹ More importantly, allocating the burden of proof to the ILEC -- particularly with regard to a proposal or fact asserted by a CLEC -- suggests a bias in favor of low UNE rates as opposed to rates that will send the correct signals for investment decisions.

¹⁴⁹ See *MN Cost Docket Order* ¶¶ 66-67, 132-35.

¹⁵⁰ See *Director, OWCP v. Greenwich Galleries*, 114 S. Ct. 2251, 2258 (1994) (noting that under the Administrative Procedure Act, 5 U.S.C. § 556(d), the proponent of a rule or order has the burden of proof, except as otherwise provided by statute, and that the “proponents of some different result, also for that purpose have a burden to maintain”).

¹⁵¹ See 29 Am. Jur.2d Sec. 158 at 184. The only circumstance in which it is appropriate to place the burden of proof on a party other than the proponent is where the other party controls or has better knowledge of the relevant facts or evidence. See *U.S. v. N.Y.N.H. H.R. Co.*, 355 U.S. 253, 256 n.5 (1957). Thus, if the Commission believes a burden of proof approach is appropriate in UNE rate proceedings, it should require that ILECs bear the burden as to their actual costs, and CLECs bear the burden as to any proposed “efficiency” adjustment.

C. The Commission Should State, Unequivocally and Without Qualification, That Its Resolution of Issues in its USF Proceeding May Not Be Relied Upon in Determining UNE Rates.

As the Commission has explained, there is a “critical difference between using the Synthesis Model (or any other model) to determine absolute UNE costs, and using it for the limited purpose of comparing relative cost differences between states.”¹⁵² The Commission has therefore repeatedly “cautioned” parties and state commissions about relying in UNE rate proceedings on “statements made in the context of universal funding.” *Notice* ¶ 47.¹⁵³

Merely “discouraging” state commissions from relying in UNE rate proceedings upon the Commission’s USF determinations, and basing that advice exclusively on the their “nationwide” character, has proven wholly inadequate to prevent the “unintended and undesirable consequences” (*id.*) of using the USF determinations and SM inputs for the purpose of developing UNE prices. Notwithstanding these “cautionary” statements, AT&T and other CLECs have invoked repeatedly the Commission’s SM inputs and other determinations in its USF proceeding -- often with considerable success -- as a basis for violating TELRIC with respect to most of the recurring cost inputs discussed above, including placement costs, structure sharing and fill factors. That fact is confirmed by the *Notice* itself, which acknowledges that based on the SM inputs, some state commissions have adopted a “backward-looking” and “erroneous” (*id.*) approach to structure sharing and placement in UNE rate determinations.

Moreover, the problems caused by the failure of the Commission to prohibit unequivocally the use of its USF decisions to determine UNE rates have been compounded by

¹⁵² 18 FCC Rcd 5212, 5265 ¶ 89 (2003)

¹⁵³ See also, 17 FCC Rcd. 7625, 7645-46 ¶ 36; *AT&T v. FCC*, 220 F.3d 607, 618 (D.C. Cir. 2000).

the references in its “cautionary” statements to the “nationwide” character of the SM inputs. These references have allowed the CLECs to argue that all other aspects of the methodology used to allocate universal service funds are appropriate for use in determining UNE rates. However, the “error” in the application to UNE rate proceedings of the approach to placement and sharing in the *Inputs Order* had nothing whatsoever to do with the “nationwide” character of the latter. Likewise, the Commission’s determination that it is error to apply to UNE rates the assumption adopted in the *Inputs Order* that 100% of switching capacity would be purchased all at once (*i.e.*, excluding “growth additions”) had nothing to do with the “nationwide” character of the SM model or its inputs.

In sum, the Commission has now taken an important step forward in rejecting for the purpose of determining UNE rates the approach to structure sharing and placement adopted in the universal service context. *Notice* ¶ 47. However, by repeating the same equivocal and ineffective statements “discouraging” the use of “nationwide” SM inputs to determine UNE rates (*Notice* ¶ 46), it has also taken a step backwards. Indeed, these statements have had the unintended consequence of allowing CLECs to convince state commissions to engage in the very practice for which the Commission has sharply admonished AT&T: “support[ing] the [SM] model where [it] favors [AT&T’s] desired outcome, but reject[ing] the model where the model does not.”¹⁵⁴ The reiteration of these statements in the *Notice* may thus encourage the same results, to the detriment of the Commission’s objectives in this proceeding.

¹⁵⁴ 18 FCC Rcd at 5264 ¶ 87. For example, AT&T was able to convince the Minnesota Commission to base inputs for switching on the SM inputs and investment, but also to adopt the same adjustment, purportedly to “correct” for understatement in the SM model of the assumed amount of “digital loop carrier” systems, that the Commission considered and rejected in the *Inputs Order*. See *Minn Cost Docket Order* ¶¶ 123-126. Significantly, AT&T offered in Minnesota no evidence in support of the proposed adjustment that it did not provide to this Commission. Indeed, the adjustment proposed to the Minnesota commission was supported by

Accordingly, the Commission should state *definitively* and *unequivocally* that it is not appropriate to rely, in whole or in part, on determinations in the universal service context for the purpose of setting UNE rates.¹⁵⁵ A definitive and unqualified statement to this effect will leave the parties free to propose, and state commissions free to determine, UNE prices in a manner consistent with the guidance issued by the Commission in this proceeding, unhindered by debates over the relevance to UNE rates of decisions that were never intended to be used for this purpose.

D. The Commission Should Reaffirm -- and Comply With -- its Commitment to Provide Additional Binding Guidance on the Interpretation and Application of its Pricing Rules Following Conclusion of this Proceeding.

In its *Triennial Review Order* (¶ 426), the Commission committed to “provide guidance and to exercise oversight of state commissions as they make determinations” regarding the obligations of ILECs to provide access to UNEs. Specifically, the Commission stated that “[a] party aggrieved by a state commission or determination may seek a declaratory ruling from this Commission, and state commissions or other parties may at any time seek a declaratory ruling where necessary to remove uncertainty or eliminate a controversy.” *Id.* In its 1996 *Local Competition Order*, the Commission reiterated a similar commitment expressly in the context of the pricing of UNEs and interconnection.¹⁵⁶

nothing more than the assertion of an AT&T witness that the SM model assumed only 18.3% of DLC systems -- the same assertion that this Commission rejected.

¹⁵⁵ This would not require the Commission to alter the SM model or other determinations in the universal service context. As the Commission has observed, any given error in the SM model may well have an attenuated effect on its intended output, the purpose of which is to identify *relative* cost differences among the states so that the Commission can allocate a fixed and limited amount of federal universal service funds. In contrast, the same error in the determination of *absolute* rate levels for UNEs may have enormous consequences.

¹⁵⁶ See *Local Competition Order*, 11 FCC Rcd at 15563-64 ¶ 125, 15813 ¶ 620.

Unfortunately, except when believing itself compelled to do so by section 271, the Commission has rarely addressed the interpretation and application of its UNE pricing rules. Thus, state commissions were allowed for *four years* to believe that they were required or permitted to use the “backward-looking” approach to structure sharing and placement that the Commission has only now confirmed to be “erroneous.” There was no reason such a fundamental misapplication of TELRIC has to continue that long.

The section 271 process, moreover, has compounded the problem. In that context, the Commission considers only whether prices *exceed* the reasonable range that would be produced by a proper application of TELRIC. Obviously, this process has not been designed or applied to identify and correct the misapplication of TELRIC that have resulted in UNE prices being set *too low*. Further, the Commission’s use of “benchmarking” in its section 271 decisions, while well-intentioned, has exacerbated the trend towards below-cost rates. For example, if the rates in the benchmark state are below TELRIC, benchmarking compounds the harm if other state commissions rely on the benchmark rates in their own arbitrations or cost dockets. Even if the benchmark rates are not below TELRIC, benchmarking can preclude the adoption of UNE rates that exceed the benchmarks but nevertheless fall within a reasonable range. For these reasons, the section 271 process has acted as a one-way downward ratchet for UNE rates.

The absence of any countervailing action by the Commission to prevent if not correct the adoption of unreasonably low UNE rates would be acceptable only if such UNE rates were permitted by the Act and caused no adverse effects. But they are *not* permitted by the Act.¹⁵⁷ And they *do* cause harm: to ILECs, other facilities-based competitors, consumers of telecommunications services, and other segments of the economy. Capital expenditures, both by

¹⁵⁷ *Local Competition Order*, 11 FCC Rcd at 15813 ¶ 620.

ILECs and actual or potential facilities-based competitors, suffer. All that remains is the “synthetic competition” and parasitic-free riding provided by reselling facilities bought and paid for by ILECs.¹⁵⁸

Although comprehensive guidance and reform of the prevailing approach to TELRIC and UNE pricing in the instant proceeding is vitally important, these will not by themselves be sufficient to prevent a subsequent deterioration similar to that experienced over the prior seven years. A matter as critical and complex as UNE pricing is particularly susceptible to disputes even at fundamental levels. Only this Commission has the authority, the claim to judicial deference, and the institutional expertise necessary to resolve the inevitable continuing disputes on a national scale.

Moreover, the Commission believes itself obligated by section 271(d)(6) of the Act to continue to review CLEC claims that UNE prices are too high. Absent reaffirmation of and compliance with its commitment to consider and resolve in other contexts issues relating to UNE prices, the downward ratcheting of UNE rates pursuant to the section 271 process is likely to continue. Indeed, the Commission’s failure to address expeditiously claims by ILECs and other parties regarding the misapplications of TELRIC that can result in rates below cost will predispose state commissions hoping to avoid meaningful review of their decisions to adopt CLEC-proposed rates that are anathema to investment.

Accordingly, parties should be encouraged to seek and obtain further binding guidance from the Commission on the proper interpretation and application of the revised pricing rules issued in this proceeding. This would be accomplished, for example, by filing petitions for declaratory rulings. The Commission should commit, and follow through on its commitment, to

¹⁵⁸ *USTA*, 290 F.3d at 424.

“act expeditiously” on such petitions. *Local Competition Order* at 15563-64 ¶ 125. The Commission should also encourage parties to seek “primary jurisdiction” referrals by federal district courts to the Commission of non-factual issues arising under complaints filed pursuant to section 252(e)(6) of the Act. *Id.* at 15563 ¶ 124.

IV. TRUE-UPS OF “PERMANENT RATES APPROVED UNDER THE GOVERNING COST METHODOLOGY” ARE UNLAWFUL, AND INCONSISTENT WITH THE POLICIES UNDERLYING THE ACT AND THE COMMISSION’S PRICING RULES

Although revised rates established pursuant to the rules adopted in this proceeding may and should differ materially than those established under the prevailing view of TELRIC, those rates may apply on a prospective basis only. *Notice* ¶ 151. Any other result would be unlawful, and inconsistent with the policies reflected in the Act and the Commission’s pricing rules. Indeed, to provide the uniform interpretation of federal law expected by Congress, and eliminate uncertainty regarding when “true-ups” are permissible and appropriate, the Commission should in its order confirm that true-ups of rates approved by state commissions “under the governing methodology” are unlawful, except under certain narrowly-defined circumstances. This is a matter of considerable urgency, for reminiscent of their claims to courts and state commissions that it would be “irrational” not to apply to UNE rates the approach to placement and structure sharing adopted in the *Inputs Order*, AT&T and MCI are now arguing to courts that state commissions may “in all instances” convert permanent rates into “interim rates subject to true-up,” that this Commission has “encouraged” this practice when it would lower rates for resale CLECs, and that the Commission’s *Notice* in this proceeding “proves” that “true-ups are authorized by federal statute and the FCC’s practice.”¹⁵⁹

¹⁵⁹ Joint Opposition of CLEC Intervenor/Defendants to Qwest’s Initial Brief on the Merits, *Qwest Corp. v. Koppendrayner*, filed Nov. 24, 2003, at 15, 17, 18.

“True-ups” are the payments that result from the retroactive application of rates different than those in effect at the time of the transactions. When required by regulators, true-ups are a classic form of “retroactive ratemaking.” Decades of federal court decisions confirm that except where the agency has complied with procedures required by the relevant statute, or otherwise indicates at the time of its initial review a problem with or question about the rates, revisions that are prescribed or approved by the agency may take effect on a prospective basis only, as demonstrated below.

At the most fundamental level, “retroactivity is not favored in the law.” *Bowen v. Georgetown University Hospital*, 488 U.S. 204, 208 (1988). “Thus, congressional enactments and administrative rules will not be construed to have retroactive effect unless their language *requires* this result.” *Id.* (emphasis added). This rule applies with special force to ratemaking. Indeed, the rule against retroactivity has been described as a “cardinal principal of ratemaking” that has long applied to “communications and energy commissioners.”¹⁶⁰

Nothing in the “language” of the 1996 Act “requires” retroactive ratemaking. To the contrary, the prohibition against retroactive ratemaking is entirely consistent with the Act’s terms. In particular, the Act requires that transactions for UNEs be governed by the terms of interconnection agreements between the parties. *See* 47 U.S.C. §§ 251(c), 252(e). The terms to be included in interconnection agreements are determined in negotiations between the parties (47 U.S.C. § 252(a)), or where negotiations fail, through arbitration by state commissions (47 U.S.C. § 252(b)). Congress expressly required that the terms to be included in interconnection agreements include the “rates” for “network elements:” section 252(a)(1) requires agreements arrived at through negotiations to include “a detailed schedule of itemized charges for . . . each

¹⁶⁰ *City of Piqua v. FERC*, 610 F.2d 950, 955 (D.C. Cir. 1979); *Illinois Bell Tel. Co. v. FCC*, 966 F.2d 1478, 1482 (D.C. Cir. 1992).

. . . network element included in the agreement.” 47 U.S.C. § 252(a)(1); section 252(c)(2) likewise requires that agreements arrived at through arbitration include “rates for . . . network elements.” 47 U.S.C. § 251(c). It thus could not be clearer from the statutory scheme that Congress wanted parties to know the rates for network elements prior to the transactions to which they would apply.¹⁶¹

The language and structure of the Act, and the presumption against retroactivity, each by itself forecloses any claim that true-ups of rates that had been approved under the governing cost methodology are lawful. Such true-ups would also be inconsistent with the objectives of the Commission’s pricing rules, and the Act’s “deregulatory” objectives.

As discussed in the *Notice* and throughout these comments, the Commission designed TELRIC to send the appropriate signals to CLECs whether it would be more efficient to invest in new facilities, or purchase them from the ILEC. The potentially “endless” “Penelope-like” process of “unraveling” UNE rates through retroactive adjustments extends the unpredictability of rates that will apply to future transactions to rates that apply to *all* transactions.¹⁶² In the Commission’s own words, this “lack of predictability is difficult to reconcile with our desire that UNE prices send correct economic signals.” *Notice* ¶ 7.

Indeed, if AT&T, MCI and other resale CLECs are able convince the courts, and state commissions in addition to Minnesota, that retroactive adjustments of permanent rates (*i.e.*, rates

¹⁶¹ Parties have sometimes suggested that an exception to the rule against retroactivity exists where the agency has given notice of the possibility (or even certainty) of retroactive adjustments based on future determinations. These suggestions are wrong. In the cases upon which these parties have relied, the agency indicated expressly at the time it approved or allowed the rates to take effect one or more substantive concerns that precluded an unqualified finding that the rates complied with governing standards. In all events, “notice” that rates may be changed retroactively merely underscores the absence of predictability and certainty.

¹⁶² See *WorldCom, Inc. v. FCC*, 308 F.3d 1, 13-14 (D.C. Cir. 2002).

found TELRIC compliant at the time of their adoption) are permissible without limitation, then all of the work by the Commission in this proceeding to ensure “predictability” and “certainty” will have gone for naught.¹⁶³ Rates that may be changed on a retroactive basis are useless for the purpose of comparison with the costs of constructing facilities or obtaining them from sources other than the ILEC. A ruling by the Commission in this proceeding that is limited to the lawfulness or propriety of true-ups based on implementation of modifications of and clarifications to TELRIC will only hasten that result, for the resale CLECs will then continue to claim, as they have to the court in Minnesota, that the Commission has suggested that true-ups of permanent rates are lawful and appropriate in all other circumstances. That is another reason why the Commission needs to impose stringent and even-handed limits on the retroactive adjustment of UNE rates found at the time of their adoption to comply with the governing cost methodology.¹⁶⁴

¹⁶³ The only “limitation” suggested by AT&T and MCI is that the state commission may not order retroactive adjustments for transactions occurring prior to a declaration by the state commission of the possibility of such adjustments. Under their view, however, nothing would prevent a state commission from making such a declaration at the time it adopts the permanent rates. AT&T and MCI have not contended otherwise, but instead claim retroactive adjustments are appropriate “in any instance” they result in lower UNE prices.

¹⁶⁴ In both instances in which state commissions in Qwest’s region ordered retroactive of adjustments of UNE rates they had previously approved under TELRIC without qualification, adjustments favored CLECs. In the Matter of Commission Review and Investigation of Qwest’s UNE Prices, Docket No. P-421/CI-01-1375 (MPUC), Order Establishing Interim Rates, April 4, 2002 ¶¶ 4-5, AZ Cost Docket Phase II and IIA, *Supplemental Order*, Decision No. 66385 (10/6/03) pp. 5-7. The arbitrary manner in which true ups have been required is underscored by the proceedings in Arizona. There, the true-ups applied to transport rates determined by the CLECs’ HAI model and found TELRIC compliant by the state commission, based on a collateral attack on the rates by another CLEC that had elected not to participate in the state commission’s UNE rate proceeding. *Id.* In the same order rejecting Qwest’s argument that retroactivity was unlawful, the state commission also rejected Qwest’s alternative request for true-ups of switching rates to undo the impact of a mathematical error in the commission’s original order -- the fact and amount of which were acknowledged by the commission’s staff and all parties to its proceeding *eight* months before it was finally corrected. *Id.*

Finally, retroactive adjustments are inconsistent with the “more market driven system” the Act was intended to create.¹⁶⁵ Absent the consent of both buyer and seller, retroactive adjustments of prices never occur in commercial markets. Even rates subject to federal regulation prior to the Act could be adjusted on a prospective basis only, as discussed above. Virtually unlimited authority on the part of state commissions to order retroactive adjustments would transform an Act intended to provide for “deregulation” into a regime even more “regulatory” than its predecessors.

¹⁶⁵ See *Pacific Bell v. Pac-West Telecomm., Inc.*, 325 F.3d 1114, 1127 (9th Cir. 2003).

For all of these reasons, the Commission should declare that rates approved by a state commission under the governing methodology at the time of their adoption are not subject to true-up unless: (1) the state commission finds that a party engaged in misconduct that (a) affected the outcome of the proceeding during which the rates were first determined and adopted, or (b) delayed the adoption, and hence the prospective application, of revised rates, or (2) the results of the original proceeding are vacated by a federal court.¹⁶⁶

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¹⁶⁶ These exceptions are similar to those recognized under the traditional rule against retroactive ratemaking. *See, e.g., ACS Anchorage v. FCC*, 290 F.3d 401, 413 (D.C. Cir. 2002)(misconduct by carrier).